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Contents

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How to use this book

The reader need not read this book again and again and by-heart it, simply read the book one or two times and then use it as a reference book like a dictionaty with the help of index provided at the end of the book. On account of dynamic nature of Indian Economy this book deliberately avoided data to the extent possible. Therefore, all the data given are only for the sake of understanding.

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Abbreviations

ADR	American Depository Receipt
AFC	Asset Finance Company
AMS	Aggregate Measurement of Support
ANBC	Adjusted Net Bank Credit
AoA	Agreement on Agriculture
ARC	Asset Reconstruction Company
ARDC	Agriculture Re-finance Development Corporation
BCCT	Banking Cash Transaction Tax
BOLT	BSE Online Trading
BoP	Balance of Payment
BSE	Bombay Stock Exchange
C	Consumption
CAC	Capital Account Convertibility
CAR	Capital Adequacy Ratio
CARDB	Cooperative Agriculture and Rural Development Bank
CD	Certificates of Deposit
CDS	Current Daily Status
CDSL	Central Depository Services Limited
CENVAT	Central Value Added Tax
CP	Commercial Paper
CPI	Consumer Price Index

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CPI (AL)	Consumer Price Index (Agriculture Labour)
CPI (IW)	Consumer Price Index (Industrial Worker)
CPI (RL)	Consumer Price Index (Rural Labour)
CPI (UNME)	Consumer Price Index (Urban Non-Manual Employees)
CPSE	Central Public Sector Enterprises
CRAR	Capital to Risk Weighted Asset Ratio
CRR	Cash Reserve Ratio
CSO	Central Statistical Organisation
CWS	Current Weekly Status
DCA	Department of Company Affairs
DSB	Dispute Settlement Body
ECB	External Commercial Borrowings
EPF	Employees' Provident Fund
ESOP	Employee Stock Option
ESOS	Employee Stock Purchase
FCNR (B)	Foreign Currency Non Resident (Bank)
FDI	Foreign Direct Investment
FI	Financial Institution
FII	Foreign Institutional Investment
FPO	Follow on Public Offering
FRBM	Fiscal Responsibility and Budget Management
FTP	Financial Transaction Plan
G	Government consumption
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariff
GDP	Gross Domestic Product

GDR	Global Depository Receipt
GII	Gender Inequality Index
GNI	Gross National Income
GNIE	Government Not Included Elsewhere
GNP	Gross National Product
GPF	General Provident Fund
HDI	Human Development Index
HDR	Human Development Report
HNI	High Net-worth Individual
HSBC	Hong Kong Shanghai Banking Corporation
HTM	Held To Maturity
HUF	Hindu Undivided Family
I	Investment
IC	Investment Company
ICOR	Incremental Capital Output Ratio
IDBI	Industrial Development Bank of India
IDR	Indian Depository Receipt
IFCI	Industrial Finance Corporation of India
IIFCL	India Infrastructure Finance Company Ltd
IHDI	Inequality Adjusted Human Development Index
IIP	Index of Industrial Production
IMF	International Monetary Fund
IPO	Initial Public Offering
ITES	Information Technology Enabled Services
LAB	Local Area Bank
LAF	Liquidity Adjustment Facility

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	Loan Company
LC	Liberalisation, Privatisation, Globalisation
LPG	London Inter Bank Offer Rate
LIBOR	Import
M	Manufacturing Value Added Tax
ManVAT	Minimum Alternate Tax
MAT	Multi Dimensional Poverty Index
MDPI	Most Favoured Nation
MFN	Memorandum of Association
MoA	Modified Value Added Tax
Mod VAT	Mixed Recall Period Method
MRP	Marginal Standing Facility
MSF	Market Stabilisation Scheme
MSS	National Bank for Agriculture and Rural Development
NABARD	Net Asset Value
NAV	Non-Banking Financial Company
NBFC	Net Demand and Time Liabilities
NDTL	National Exchange Automated Trading
NEAT	Net Factor Income From Abroad
NFIA	National Housing Bank
NHB	Net National Product
NNP	Net National Product at Factor Cost
NNPFC	Net National Product at Market Price
NNPMP	Non Performing Asset
NPA	Non-Profit Institutions Serving Households
NPHIs	Non Resident (External) Rupee Account
NR (E) RA	

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NRO	Non Resident Ordinary Rupee account
NSC	National Saving Certificate
NSCCL	National Securities Clearing Corporation of India Limited
NSDL	National Securities Depository Limited
NSE	National Stock Exchange
NSSF	National Saving Scheme Fund
NSSO	National Sample Survey Organisation
NT	National Treatment
NTB	Non Tariff Barrier
OBE	Off- Balance Sheet Exposure
OME	Oil Marketing Enterprise
P	Price
PACS	Primary Agriculture Credit Societies
PD	Primary Dealer
PLB	Poverty Line Basket
PMI	Purchasing Manager's Index
PPP	Purchasing Power Parity
PPP US $	Purchasing Power Parity at US dollar
PSU	Public Sector Undertaking
Q	Quantity
QIB	Qualified Institutional Buyer
RBI	Reserve Bank of India
RRB	Regional Rural Bank
SBI	State Bank of India
SC	Scheduled Caste
SCB	State Cooperative Bank

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SDR	Special Drawing Right
SEBI	Securities and Exchange Board of India
SLR	Statutory Liquidity Ratio
SNA	System of National Accounts
STT	Securities Transaction Tax
ST	Scheduled Tribe
TRIMS	Trade Related Intellectual Measures
TRIPS	Trade Related Intellectual Property Rights
UNDP	United Nations Development Programme
URP	Uniform Recall Period Method
UPS	Usual Principal Status
USD	United States Dollar
VAT	Value Added Tax
WIPO	World Intellectual Property Organisation
WPI	Wholesale Price Index
WTO	World Trade Organization
X	Export

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CHAPTER 1

INTRODUCTION TO ECONOMICS

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There are many definitions for economics. As the subject keeps on evolving, the definition also keeps on evolving. The father of economics Adam smith studied economics as “an inquiry into the nature and causes of the wealth of nations”.

Thereafter, a lot many economists defined economics in different ways based on their own research and perception. But none of them is universally accepted. So, it is better to have an idea about economics rather than having a definition. This is a study that centres on resources. The resource may be abundant or scarce; natural or manmade; monetary or non monetary.

It is said above for the reason the horizon of economics is widened. Economics deals with the scarce resources like diamond and also air a resource available in plenty. It speaks about the price of both. It points out the scarce nature of diamond as reason for its high price and as the air is available in plenty it is not priced. Adam Smith in his wealth of nations observes “The things which have the greatest value in use have frequently little or no value in exchange; and, on the contrary, those which have the greatest value in exchange have frequently little or no value in use. Nothing is more useful than water: but it will purchase scarce anything; scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it.”[1] He discusses about the exchange value of both water and diamond. The first one is available in plenty, the second one is scarce. So, it is clear that it studies about both plentifulness and scarcity. The causes and effects of inflation is also studied which is related with abundance of money as well as scarcity or shortage of goods and service. From this it is clear that economics studies both scarcity and abundance. But most part of the economic study is devoted for the study of scarcity as human tendency is to care for scarce resources.

It is stated as a study that centres on resources for the reason it not only study about resources but also the factors, stake holders involved in creation, extraction and consumption. It studies about the allocation of resources, allocation of factors of production, consumption pattern of factors of production, the motive and aim of factors of production, behaviour of factors of production and consumers and the psychology behind these motives and aims and behaviour and so many other things.

Factors of production mean the participants in the production process. They are Land, Labour, Capital and Entrepreneur. The land is a base to establish the production unit, transportation and sometimes the source of raw material. Labour contributes her might physically and mentally. Capital is used to purchase the men and material. Entrepreneur does bring in all other factors of production and puts in to use to produce

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1 Macroeconomics, theory and policy, thoroughly revised edition, H. L Ahuja, P. 26

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what best can be produced using these. The entrepreneur may be either government or private.

A STUDY UNDER CONTROLLED ATMOSPHERE

In the technical specifications of a car the mileage of the car is mentioned say for example 22 Kilometre per Litre (KMPL). It means the car runs for 22 Kilometres per litre of fuel. But when it is bought and used it may not run 22 Km per litre. Had you ever thought why does this difference arise? The difference is due to the fact that the 22 KMPL is mentioned after a thorough check under certain laboratory conditions like well laid road, perfect air pressure in tyre, traffic free atmosphere etc. but in actuality, all the roads are not well laid, and the city traffic may be heavy, the air pressure may not be maintained properly all the time. These factors reduce the mileage of the car.

Likewise, certain varieties of seeds yield a high amount of produce in laboratory or in field trial but when it comes to mass scale production by farmers, the yield may not be the same. The reasons are difference in atmospheric and other conditions of laboratory and field.

The same logic is applicable for economics. The laboratory conditions are laid in the form of assumptions when it comes to the study of Economics. The economic theories and models are created under specific conditions and assumptions. For example, the demand theory considers that demand for goods and services are based on the level of price for that particular goods and service. It says, if the price is high, the demand for the product is low and vice versa. It is said so because, the theory of demand assumes other factors that has impact on demand remain unchanged. But in actuality it is not the case. There are many other factors other than the price that has influence on the demand. The reason for making these assumptions are that the factors considered in theory are playing major role in deciding the outcome of the interplay of these factors . The other things do not have a significant influence but at the same time they cannot be ignored. The second reason for assumption is to simplify the study and build a base theory based on which further complicated study can be done by considering all other factors that have impact or influence on the issue under consideration. The assumption of other variables being unchanged is called *Ceteris paribus*. The economic Times Defines *Ceteris paribus* as "This commonly-used phrase stands for 'all other things being unchanged or constant'. It is used in economics to rule out the possibility of 'other' factors changing, i.e. the specific causal relation between two variables is focused."[2]

The way, the laboratory checked cars and seeds yield less on the field the economic

2 http://economictimes.indiatimes.com/definition/ceteris-paribus - the web page accessed on 25.1.2014

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theories deliver less in practice as the world is more complicated than what was considered while building economic theories and models. But the economic theories and models do not fail the world as due care is taken while building it and framing it to make as much as closer to the realities of the world.

TWO MAIN STREAMS

There are two main streams of Economics. They are Microeconomics and Macro economics.

The term 'Micro' is used to indicate something relating to a specific area, rather a general one. The term 'Macro' is used to denote something relating to a general area rather than being detailed or specific. Likewise, the micro economics studies the specific area of economics like individuals, a smaller group like labourers, economics of a firm etc. The macro economics studies the economy of a nation as a whole.

The study of demand of individuals, the production function of a production unit which is called firm are covered under microeconomics study. At the same time the study of demand of the nation, the production or supply level of a nation, the general level of employment etc. are covered under the study of Macroeconomics.

A careful reading of the following table will give clarity on the question as to what is microeconomics and what is macroeconomics.

Issue Considered	Is it Micro?	Is it Macro?
Quantity of orange demanded by Asstha Mathur	Yes	NO
Quantity of Orange demanded by North East India	Yes	No
Quantity of Orange demanded by India	Yes	No
Quantity of all products demanded by India	No	Yes
Price of Orange in Nagpur	Yes	No
Price level of All products in India	No	Yes
Level of Employment in Iron and Steel Industry	Yes	No
Level of Employment in India	No	Yes

This book looks at Indian economy from the macroeconomic perspective. But do not dwell into theoretical aspects. It concentrates on the concepts and its practical implications.

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CHAPTER 2

NATIONAL INCOME

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In this Chapter, I will learn

- MEASURES OF NATIONAL INCOME
- METHODS OF MEASURING NATIONAL INCOME
- ESTIMATES OF NATIONAL INCOME IN INDIA
- RELATED TERMS

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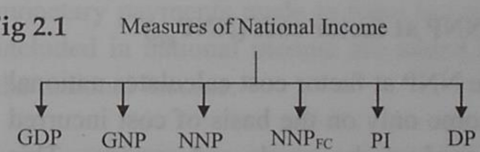
National income of a country is the total value of all final goods and services produced in the country in a particular period of time usually, one year. The growth of national income helps to know the progress of the country.

This chapter covers the measures of national income, methods of measuring the national income and estimates of the national income in India.

MEASURES OF NATIONAL INCOME

There are various measures of National income. Each of these measures the national income in a different perspective. They are similar to one another and shown in the following figure 2.1.

Fig 2.1



1. Gross Domestic Product (GDP)

Here the catch word is "domestic". It refers to the geographical area. Gross Domestic Product is the total value of all final goods and services produced within the boundary of the country during a given period of time, generally one year. Here the produce of resident citizens as well as foreign nationals who reside within that geographical boundary is considered.

GDP = Q x P

Where, Q is the total quantity of final goods and services produced in the country (both by Indians and foreigners residing within Indian boundary)

P is price of the final goods and services,

Take an example, there are 40 Crore Indians who earn ₹ 400 Crore in Indian Territory and there are 1 Crore foreigners who earn ₹ 10 Crore in Indian Territory and send the money to their respective country. At the same time there are 2 Crore Indians living abroad who earn ₹ 40 Crores and send the money to India. The GDP is only ₹ 410 Crores, because here we include the income earned in the Indian Territory i.e. ₹ 400 Crores earned by Indians and ₹ 10 Crores earned by foreigners.

2. Gross National Product (GNP)

Here the catch word is "national". It refers to all the citizens of the country. Gross National Product is the total value of the total output or production of final goods and services produced by the nationals of a country during a given period of time, generally one year. In this case, the income of all the resident and non-resident citizens of a country is included whereas the income of foreign nationals who reside within the geographical boundary of the country is excluded.

This can be calculated from the GDP.

GNP = GDP +(X-M)

Where, GDP = Gross Domestic Product

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X (export) = inward remittances of a country in respect of the goods produced and services rendered (exported) by nationals of a country abroad.

M (import) = outward remittances of a country from the goods produced and services rendered by foreign nationals of the country in the domestic area.

X-M is called as Net Factor Income from Abroad (NFIA). So,

GNP = GDP + net factor income from abroad.

Take the same example cited in GDP. The ₹40 Crores earned by Indians abroad and sent/remitted to India is X (export) and ₹ 10 Crores income earned and sent/remitted by foreigners to their respective country is M (Import). So the GNP is 440 Crores.

₹ 440 Crores = ₹ 410 Crores + (₹ 40 Crores – ₹ 10 Crores)

Here the income earned by foreigners in India is excluded and income earned by Indians abroad is included. Finally, the GNP contains the income earned by Indian Nationals (both in Indian Territory and abroad) only.

3. Net National Product (NNP)

Net National Product is arrived after deducting depreciation from gross national product. Depreciation means wear and tear of goods produced. This deduction is done because a part of current produce goes to replace the depreciated parts of the products already produced. This part does not add value to current year's total produce. It is used to keep the products already produced intact. So, it is deducted.

NNP = GNP – Depreciation

Here, the Net National Product is calculated with market price. The market price includes indirect taxes and excludes subsidies that are made to produce goods and services. The market price is less than the cost by the amount of subsidies. So, subsidies are deducted to arrive at market price.

For example, the cost of production of a product is ₹ 100. If government gives a subsidy of ₹ 20, the price of product will be reduced by ₹ 20, that is ₹ 80. This is called NNP at Market Price (NNP_{MP}).

4. NNP at factor cost (NNP_{FC})

The NNP at factor cost calculates national income only on the basis of cost incurred to produce the goods and services. This cost is the payment made to the factors of production. The factors of production are land, labour, capital and entrepreneur. For this, the indirect tax is deducted from $NNP_{\text{at market price}}$. Then the subsidies given to produce goods and services are added.

$NNP_{\text{at factor cost}} = NNP_{\text{at market price}}$ – Indirect taxes + subsidy

In fact, for NNP at factor cost we use the term National Income.[1]

1 Macroeconomics, theory and policy, thoroughly revised edition, H. L Ahuja, P. 26

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Likewise, $GDP_{\text{at factor cost}}$ also can be calculated.

$GDP_{\text{at factor cost}} = GDP_{\text{at market price}}$ – Indirect taxes + subsidy

5. Personal Income (PI)

Personal Income is the sum of all the income received by the entire people of the country in one year[2]. The whole national income is not available to individuals of a country. Some parts of national income are not available to individuals of the country. At the same time, some monetary payments made to them is not included in national income. So, to calculate Personal Income, parts of national income that are not available to individuals of the country is deducted from the national income. The monetary payments made to them but not included in national income are added to the national income.

Personal Income = National income + [(Transfer payments) – (Undistributed profits of corporate + Payments for social security provisions)]

Personal Income = National income + net transfer payment

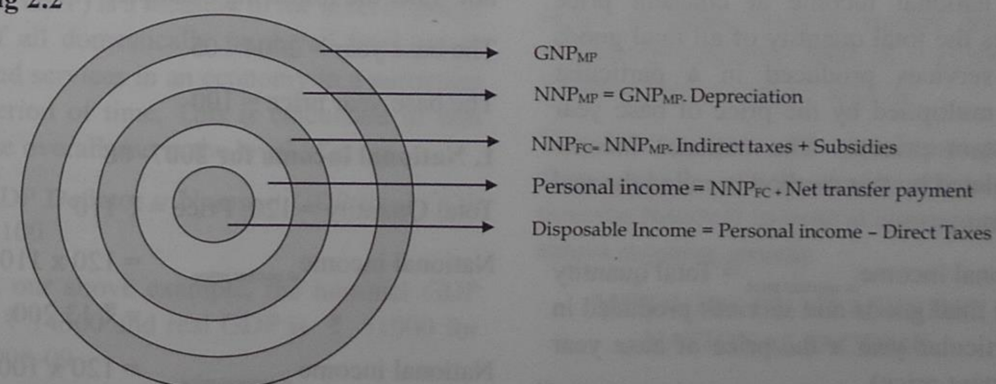
Usually the corporates do not distribute the whole profit to shareholders. A portion of profit is kept with them to meet future expenditure and expansion. This is called undistributed profits of the corporates.

Payment for social security provisions are payments made by employees towards pension and provident fund.

Transfer payments means the payments that are made not against any productive activity on the part of the receiver. The examples are old age pension, unemployment compensation, disaster

A graphical representation that shows relationship between various measures[3]

Fig 2.2



2 Macroeconomics, theory and policy, thoroughly revised edition, H. L Ahuja, P. 26

3 In the figure if net transfer payment is negative the personal income will be higher than $NNP_{\text{at factor cost}}$

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relief payment, interest paid on public debt, etc.

6. Disposable Personal Income (DPI)

Disposable Personal Income means the income that is available to individuals that can be disposed (spent) at their will. All the personal income cannot be spent by individuals. They have to make direct tax payments like income tax. These have to be deducted to arrive at the Disposable Personal Income.

Disposable Personal Income = Personal Income – Direct Taxes

National Income at Constant Price and Current Price

To calculate and compare the national income of various years, the national income is calculated with reference to a particular year. That is called the base year. The price in this year is called price of base year or constant price.

The national income at constant price means the total quantity of all final goods and services produced in a particular year multiplied by the price of base year (constant price). The national income calculated by this method is called the real income.

National income$_{\text{at constant price}}$ = Total quantity of all final goods and services produced in a particular year **x** the price of base year (constant price).

National Income at current price means the total quantity of all final goods and services produced in a particular year multiplied by the price of that particular year (current price). The national income calculated by this method is called the nominal income.

National income$_{\text{at current price}}$ = Total quantity of all final goods and services produced in a particular year **x** the price of the goods and services in that particular year (current price)

For example, take 2004-05 as base year.

National income for 2008-09$_{\text{at constant price}}$ = Total quantity of all final goods and services produced in 2008-09 **x** the price of 2004-05

National Income for 2008-09 at current price = Total quantity of all final goods and services produced in 2008-09 x the price of 2008-09

The reason behind calculating National Income at constant price is to check whether the National Income has grown or not. Take the following example.

The base year = 2004 - 05

The base year price = 100

1. National income for 2007- 08

Total Quantity = 120; Price = ₹ 110

National income$_{\text{at current price}}$ = 120 x 110

= ₹ 13,200

National income$_{\text{at constant price}}$ = 120 x 100

= ₹ 12,000

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2. National income for 2008-09

Total Quantity =110; Price = ₹ 130

National income$_{\text{at current price}}$ = 110 x 130

= ₹ 14,300

National income$_{\text{at current price}}$ = 110 x 100

= ₹ 11,000

The National Income for 2008-09 at current price is ₹ 14300 which is higher than the National Income for 2007-08 at current price of ₹ 13200. But National income for 2008-09 at constant price is ₹ 11000 which is less than the National Income for 2007-08 at constant price of ₹ 12000. This is because, the actual quantity produced in 2008-09 is less than that of 2007-08. It means, no real growth has taken place in 2008-09. The high income at current price is due to the increase of price in the year 2008-09.

GDP Deflator

The GDP deflator (implicit price deflator for GDP) is a measure of the level of prices of all domestically produced final goods and services in an economy in a particular period of time. This is calculated to find the overall rise in the level of price.

GDP Deflator = Nominal GDP/Real GDP x 100

In our above example, the nominal GDP is ₹ 14300 and real GDP is ₹ 11000 for 2008-09

GDP Deflator = 14300/11000 x 100 = ₹ 130

Therefore the price is 130 %. It means price rise of 30 % i.e. (130 - 100 = 30)

If the increase in price is already known, the real GDP can be calculated from nominal GDP.

Real GDP = Nominal GDP / GDP deflator.

National Income Growth

National income growth$_{\text{at current price}}$ = (National Income of this year$_{\text{at current price}}$ - National Income of previous year$_{\text{at current price}}$) / National Income of previous year$_{\text{at current price}}$ x 100.

In our example,

National income growth$_{\text{at current price}}$ for 2008 - 09 = (14300 - 13200)/13200 **x** 100

= 8.33 %

National income growth$_{\text{at constant price}}$ = (National Income of this year$_{\text{at constant price}}$ - National Income of previous year$_{\text{at constant price}}$) / National Income of previous year$_{\text{at constant price}}$ x 100.

In the example, National income growth at constant price for 2008-09 = (11000 - 12000)/12000 x 100 = - 8.33 %

The National Income at current price shows positive growth whereas at the same time the National Income at constant price shows negative growth.

METHODS OF MEASURING NATIONAL INCOME

Various measures of National Income described above, can be measured by

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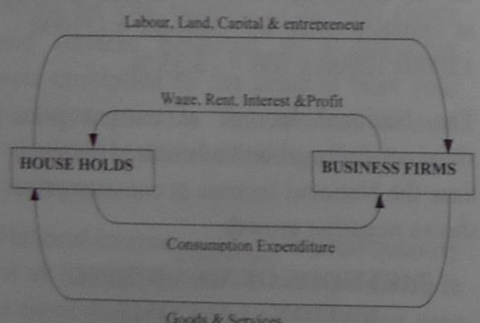
different methods. Before learning the methods, there is a need to see the flow of income between the different players who take part and contribute to the National Income.

There are four players namely, individuals or households, business firms or investors, government and foreign nationals. For the sake of simplicity, we consider only the first and second.

The diagram in the next page shows circular flow of income between households and business firms. The upper part shows the supply side of economy and the lower part shows the demand side of the economy.

In the upper part, the households supply factors of production viz., labour, land, capital and entrepreneur to business firms to produce goods and services. In return, the business firms gives wage, rent, interest and profit to labour, land, capital and entrepreneur respectively.

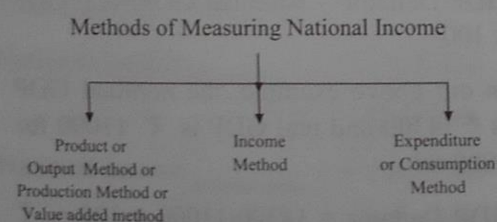
Fig 2.3 A graphical representation of flow of income



The wage, rent, interest and profit are expenditure to business firms but income to households. So, one's income is other's expenditure. Hence, it is evident that the expenditure of one player and the income of another player are equal. So, National Income can be calculated by compiling of income of all or expenditure of all. The calculation of National Income by compiling income of house hold is called **Income Method**.

The bottom of the figure shows the flow of goods and services that are produced by business firms and demanded by the people. For the flow of goods and services produced and supplied by business firm, households pay money. Here, the value of goods and services produced (price x quantity) is equal to the expenditure incurred by households on purchase of those goods and services. Both are equal. So, the National Income can be calculated by calculating the total value of all goods and services or by compiling total expenditure incurred by the people. The former is called **Product Method (or) Output Method (or) Production Method**. The latter is called the **Consumption Method (or) Expenditure Method.** This is shown in the following figure 2.4.

Fig 2.4



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1. Product Method (or) Output Method (or) Production Method

In this method, the National Income is compiled by calculating the gross value of final goods and& services produced in a country in one year. "GDP is a concept of value added. It is the sum of gross value added of all resident producer units (institutional sectors, or industries) plus that part (possibly the total) of taxes, less subsidies, on products which is not included in the valuation of output. Gross value added is the difference between output and intermediate consumption."[4]

Gross Value added = Output of final goods and services – Intermediate consumption

GDP = Gross value added + Indirect taxes – Subsidy

2. Income Method

Under Income Method, the National Income is calculated by compiling income of factors of production viz., labour, land, capital and entrepreneur.

National Income = Total wage + Total rent + Total interest + Total profit.

The approach above mentioned is a Macro economical theoretical approach. In the Indian context, it is slightly different as per 1993 SNA (System of National Accounts) framework. It is total of the following.

GDP = Compensation of employees + Consumption of fixed capital + (Other taxes on Production – Subsidies on production)+ Gross operating surplus

Compensation of employees means the salaries paid in cash and kind and other benefits provided to employees engaged in production of goods and services. To put it simply it is 'wage'.

Consumption of fixed capital means wear and tear of machinery. These are replaced with new parts or machinery. It adds to income of machinery and spare parts producers. So, it is added here.

Other taxes on production minus the subsidies are the net tax on production. There is a difference between tax on products and tax on production. Tax on product includes taxes like sales tax and excise duty.

It is the tax imposed as it was produced and sold. Tax on production means, tax imposed irrespective of production like license fees and land tax.

Gross operating surplus is the balance of value added after deducting the above three components. It goes to pay rent of land and interest of capital.

3. Consumption Method (or)

Expenditure Method

In Consumption Method (or) Expenditure Method, the consumption expenditure of consumers (C), consumption expenditure of investors or entrepreneur which is called investment (I), and consumption of

4 National Accounts Statistics Sources and Methods 2007 (http://mospi.nic.in/rept%20_%pubn/ft-est.asp?rept_id=nad09_2007&type=NSSO)

government (G) is added.

GDP = C + I + G

This formula can be extended as follow, as per 1993 SNA framework.

GDP = Household final consumption expenditure + Consumption expenditures incurred by general government and NPHIs + Saving + Gross capital formation

Where,

C = Household final consumption expenditure

I = Saving + Gross capital formation

G = Consumption expenditures incurred by general government and NPHIs

Household final consumption expenditure consists of expenditure of resident households on consumption of goods or services.

Consumption expenditures incurred by general government consists of expenditure on welfare scheme and others and NPHIs (Non-profit institutions serving household) are similar to expenditure incurred by non – profit organisations like NGOs.

Saving is the amount that is not spent on consumption, but saved.

Gross capital formation is the investment made on fixed assets.

Suitability of Method

No method is universally applicable. The product method is suitable to calculate income from primary (agriculture, forestry etc.) and secondary (industry, mining etc.) sectors. In these sectors, tangible products are produced. So, it is easy to count and multiply them with the price. In tertiary (service) sector, no tangible products are produced. For example, it is not possible to calculate the output from teaching profession. So, product method is difficult. Here, the income of all those engaged in teaching profession can be summed up. Hence, it is better to use product method in primary and secondary sectors and income method in tertiary sectors.

Incremental Capital Output Ratio (ICOR)

Capital output ratio (COR) is the ratio between capital and output. In formulaic form,

Capital output ratio = Capital / Output

It shows the amount of capital required to produce a product.

Incremental capital output ratio means the additional amount of capital required to produce one additional product.

ICOR = Incremental Capital / Incremental Output

It helps to calculate the amount of capital investment required to achieve a target growth rate.

Growth rate = Capital investment/ ICOR

Or

Capital investment = Growth rate x ICOR

For example, if the ICOR is 4 and targeted

growth rate is 8%, the required investment is 32%.

32 = 8 x 4

This formula has been used by Harrod – Domar in their growth models.

ESTIMATES OF NATIONAL INCOME IN INDIA

The calculation of National Income dates back to pre-independence period. This is updated, modified and fine tuned to the changing time.

Before Independence

In 1868, Dadabhai Naoroji wrote a book named "Poverty and Un British Rule in India". In that book, he estimated per capita income of Indians as ₹ 20. Thereafter, following persons have also calculated the per capita income.

Findlay Shirras (1911) - ₹ 49.00

Wadia & Joshi (1913 – 14) - ₹ 44.30

For the period of 1925-29, Dr. V. K. R. V. Rao calculated per capita income of Indians as ₹ 76. He was the first person to estimate National Income scientifically with a proper method.

After Independence

National Income Committee was formed in 1949 under the chairmanship of Prof. P.C. Mahalanobis. It submitted its first report in 1951 and final report in 1954. It reported that the per capita income was ₹ 246.90 for the period of 1950 – 54.

Later, the Central Statistical Organisation (CSO) was formed. The first official estimate by CSO was in 1956 with base year 1948 – 49.Base year has been shifted six times so far i.e. 1960 – 61, 1970 – 71, 1980 – 81, 1993- 94 and 1999 – 2000 and the year 2004 - 05 is the new base year from 2005 – 2006.

RELATED TERMS

Index of Industrial Production (IIP)

It measures the growth of industrial production in India. This index classifies industries into Mining, Manufacturing and Electricity sectors and measures growth in production in each industry. In addition, use based classification of basic goods, intermediate goods and capital goods is also available. This helps in predicting GDP growth as Industry is one of the major contributor to growth. IIP is released by CSO on a Monthly basis.

Purchasing Manager's Index (PMI)

Purchasing Manager's Index predicts the level of industrial production in advance. It predicts the industrial production by tracking the following parameters: new order flows, stocks of items purchased, backlogs of work, employment levels and suppliers' delivery times. This is done by surveying purchasing executives over 500 manufacturing companies in India. In India, it is released by HSBC in partnership with Markit, a global financial information service company. The index above 50 reflects expansion and below 50 reflects contraction in the industrial production.

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CHAPTER 3

HUMAN DEVELOPMENT[1]

1 This chapter heavily draws its content from HDR 2010.

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CHAPTER 3

HUMAN DEVELOPMENT

In this Chapter, I will learn

- DIMENSIONS, INDICATORS AND GOAL POSTS FOR CALCULATING THE HDI
- CALCULATION
- NEW INDICES

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The human development in the past was measured by per capita income, as income helps human beings to fulfill their basic needs. If per capita income is high, it means that the level of human development is also high and vice versa. But, there were many short comings in this method. It is just an average of National Income. It cannot reflect the correct picture of level of human development. For example, the rich may not spend income to increase their standard of living instead they may keep in saving or spend on things which are injurious to health. So, the per capita income is not a proper measure of Human Development.

So, the concept of human development was broadened beyond per capita income and included the level of achievement in education and health aspects as well. It has to be kept in mind that human development is not confined to these three alone. It is evident from the following observation: "However human development does not end there, other choices highly valued by many people, range from political, economic and social freedom to opportunities for being creative and productive and enjoying self-respect and guaranteed human rights".[2]

As said in the above description, human development is measured by three dimensions viz, Health, Education and Standard of living. These dimensions are measured using different indicators (which follows in detail) computed as three indices (sub-indices). These three indices are averaged and computed as Human Development Index (HDI) (master index).

The United Nations Development Programme (UNDP) defines HDI as follows: "The Human Development Index (HDI) is a summary measure of human development. It measures the average achievements in a country in three basic dimensions of human development: a long and healthy life, access to knowledge and a decent standard of living."[3]

The human development index was developed by Mahbub-ul-Huq along with Amartya Sen. This is used by UNDP. The UNDP brings annual report called Human Development Report (HDR) since the year 1990. The method developed by them was followed till 2009 (old method) and the 2010 (20th anniversary edition) (new method) Report adopted a slightly different method. And three new indices were introduced viz., Gender Inequality Index, Multi-dimensional Poverty Index and Inequality-adjusted HDI.

This chapter highlights the different dimensions, indicators, goal posts and calculation of HDI for both New and Old method. In addition, three new indices are also dealt with in this chapter.

2 Human Development Report 1997

3 http://hdr.undp.org/en/media/HDR_ 2010_EN_ TechNotes_reprint.pdf

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DIMENSIONS, INDICATORS AND GOAL POSTS FOR CALCULATING THE HDI

Dimensions

The basic dimensions viz, Health, Education and Standard of living remain same but the indicators used to measure these dimensions, goal posts (maximum and minimum values) and method of computing sub index and master index (HDI) has changed in the Twentieth anniversary edition. The table 3.1 shows the dimensions, indicators and goal posts.

Indicators and Goal Posts

The indicator for Health that is life expectancy at birth, remains the same

Table 3.1.Dimensions, Indicators and Goal posts for Calculating the HDI

Dimensions	Indicators		Maximum Value		Minimum Value	
	Old	New	Old	New	Old	New
Health	Life expectancy at Birth (years)	Life expectancy at Birth (years)	85	Observed Value*	25	20
Education	a) Adult Literacy rate (%)	a) Expected years of schooling for a school-age child	100	Observed value	0	0
	b) Combined Gross Enrolment Ratio (%)	b) Mean years of prior schooling for adults aged 25 and older.	100	Observed value	0	0
Standard of Living	GDP per capita (PPP US $)	GNI per capita (PPP US$)	40,000	Observed value	100	Observed value

Source: HDR 2009 and 2010

*Observed value means the actual value observed maximum or minimum value as the case may be from 1980 to the current year

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for both New and Old method. The life expectancy is the average number of years people are expected to live. It is a probability calculation. It is calculated using the birth and death data of past.

The indicators for Education in the old method are the Adult literacy rate and the combined gross enrolment ratio. The indicators in the new method are Expected years of schooling for a school-age child and Mean years of prior schooling for adults aged 25 and older. Mean years of schooling is estimated based on duration of schooling at each level (primary, secondary and higher) of education. Expected years of schooling estimates are based on enrolment by age at all levels of education and population of official school age for each level of education. In the old method, the educational achievement is measured by just bifurcating the populace as literate and illiterate and enrolled and not enrolled. But the new indicators measure the educational achievements qualitatively. It measures the sustainability of enrolment by measuring the expected and average years of schooling.

The indicator for standard of living is changed from Gross Domestic Product (GDP) per capita to Gross National Income (GNI) per capita. The GDP per capita does not give the picture of how much of national produce accrues to the people of the country but GNI per capita gives a correct picture as it excludes the out flow of remittances and includes inflow of remittances, foreign aid etc. Therefore, GNI per capita is better than GDP per capita and so, it is included.

Goal Posts

The goal posts are necessary to convert the values as unit less index that range from 0 to 1. The value change from 0 towards 1 shows progress.

In old index the goal posts were prefixed ones. It puts a 'base' and a 'cap'. The base doesn't have any scientific basis. But in the new index the minimum value is fixed either at a point below which the human kind cannot survive or at the actually observed point that is the value actually observed from 1980 to the current year. If life expectancy is below 20 years (the reproduction age) human kind cannot survive that is why the minimum value is fixed at 20 years. The HDR 2010 explains the rationale behind this as follows: "If a society or a subgroup of society has a life expectancy below the typical age of reproduction that society would die out".

A society can survive without education. That is why, the minimum values are fixed at zero. For income, it is observed value. For example the observed value for HDR 2010 is PPP US $ 163 per capita GNI (Zimbabwe's per capita in 2008 lowest in that period). Zimbabwe survived with this income. This shows that human kind can survive with this income. That is why this amount is fixed as minimum.

In the old method, the maximum value was fixed for education at 100 percent, for

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health at 85 years and for standard of living at PPP$ 4000. These are artificial caps. In the new method for all these three it is observed value. For example, maximum level of life expectancy observed is 83.2 years (Japan, 2010) for HDR 2010.

CALCULATION

The calculation method has also undergone some change in the New method. The sub index (Dimension index) calculation method remains the same for health. For education in old method, Adult literacy was assigned 2/3 weight and enrollment ratio was assigned 1/3. Then both of them added to one. But in New method, both the indices viz., Expected years of schooling and Average years of schooling are given same weightage and their Geometric mean is added to one. Performance for these dimensions is expressed as a value between 0 and 1 by applying the following formula:

Dimension Index = (Actual value – Minimum Value)/(Maximum value – Minimum Value)

But for income in the Old method log to the base 10 was used to calculate the index. The reason for using log is that, beyond a certain level, the income does not enhance the human capability much. In other words, the ability of income to increase human capability diminishes with increase in income. The log value assigns less importance to higher value. For example, the log value of 2 is 0.301 and log value of 8 is 0.903. Here, the number 8 is four times higher than the number 2 but the log value is only three times higher. This means, the importance of higher value is getting diminished. So, the **law of diminishing capability of income** is ensured.

In the New method, instead of log to the base 10, natural logarithmic value is used. The natural logarithm is denoted by ln or $\log_e$. The value of e is 2.718. There is no valid reason for this change except that mostly economic literature uses natural log for income. The HDR 2010 observes the reason as follows: "This minor change has no effect on the value of the income index and is motivated by the fact that most of the economic literature uses the natural logarithm of income".

The method of converting the absolute value into indices by using the above formula is called **normalisation**.

HDI is then calculated as an arithmetic mean of the three dimension indices in the old method but in the New method it is calculated as Geometric mean. The arithmetic mean is influenced by extreme values that arise due to an uneven development across dimensions. This implies that low level of achievement in one dimension is compensated by higher level of achievement in another dimension, whereas geometric mean is a stable one not influenced much by extreme values. Therefore, Geometric mean is adopted in New method. This can be explained by an example.

Let us consider the following two cases.

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Case 1

Education index: 0.4

Health index : 0.6

Arithmetic mean = 0.4+0.6/2 = 0.5

Geometric mean = 0.489

Case 2

Education index: 0.8

Health index : 0.2

Arithmetic mean = 0.8 + 0.2/2 = 0.5

Geometric mean = 0.4

Here, compared to the first case, health index fell down by 0.4 points in the second case but this is compensated by rise in education index by 0.4 points. The arithmetic mean ensures this because, in both the cases, arithmetic mean remains the same at 0.5. It means that rise in education index substitutes fall in health index. But the geometric mean doesn't remain same. It comes to 0.4 points from 0.489 because it gives less importance to higher value. Here the rise of 0.4 points in education index is less than adequate to compensate for fall of 0.4 points in health index. So the overall index comes down. Hence the perfect substitution like that of arithmetic mean doesn't take place.

Old Method

Example

Actual values:

Life Expectancy at birth = 66 years

Adult literacy rate = 86

Gross enrollment = 56

GDP per capita (PPP US$) = $ 8,840

1. Life Expectancy Index/Health Index

= (66 – 25)/(85 – 25)

= 41/60

= 0.683

2. Education Index

Adult Literacy Index

= (86–0) / (100 – 0)

= 0.860

Gross Enrollment Index

= (56 – 0)/(100 – 0)

= 0.560

Education Index

= 2/3 (0.860) + 1/3 (0.560)

= 0.759

3. Income Index/ Standard of living Index

= [log (8,840) – log (100)] / [log (40,000) – log (100)]

= 3.946 – 2 / 4.602 – 2

= 0.748

4. HDI

HDI = (Health index + Education index + Per capita index) / 3

= (0.683 + 0.759 + 0.784)/3

= 0.742

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New Method

Example

Table 3.2. Dimensions, Indicators, Goal Posts of Observed Maximum and Minimum Value

Dimensions	Indicators	Goal Posts	
		Observed Maximum	Minimum
1. Health	(i) Life expectancy at birth	83.2 (Japan, 2010)	20 years
2. Education#	(i) Mean years of schooling	13.2 (United States, 2000)	0
	(ii) Expected years of schooling	20.6 (Australia, 2002)	0
3. Standard of living	Per capita GNI (PPP US $)	108,211 (UAE, 1980)	163 (Zimbabwe, 2008)

Source: HDR 2010 (For observed values)

The combined education index maximum observed 0.951(New Zealand 2010). This observed value is used to calculate combined education index for other countries.

Table 3.3. Sample Actual Value

Dimensions	Indicators	Actual value
1. Health	Life expectancy at birth (years)	64.4
2. Education	(i) Mean years of schooling (ii) Expected years of schooling	4.4 10.3
3. Standard of living	Per capita GNI (PPP US $)	3337

1. Life expectancy index/ Health Index

= 64.4 – 20/83.2 – 20 = 0.702

2. Education Index

Mean years of schooling

= 4.4 - 0 /13.2 – 0

= 0.333

Expected years of schooling

= 10.3 – 0 / 20.6 – 0

= 0.5

Education index

= √0.333 x 0.5-0/0.951-0

= 0.408

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3. Income index/Standard of Living Index

= In (3,337) – In (163) / In (108,211) – In (163)

= 0.406

HDI = √0.702 x 0.408 x 0.406

= 0.5088

NEW INDICES

As already said, the 20th anniversary edition introduced three new indices namely Multidimensional Poverty Index, Inequality-adjusted HDI, and Gender Inequality Index. These are shown in the following figure 3.1.

Fig 3.1

New Indices

Multi-Dimensional Poverty Index | Inequality adjusted HDI | Gender Inequality Index

Multi-Dimensional Poverty Index (MDPI)

Multi-dimensional poverty index measures the deprivation of people in health, education and standard of living. It is obverse of HDI while HDI measures the level of achievements of people in the dimensions of health, education and standard of living the MDPI index measures the under achievement in these dimension. For example HDI measures average years of schooling but MDPI counts households in which no one has completed five years of schooling. The dimensions and indicators are shown in the following table 3.4.

Table 3.4. Dimensions and Indicators of Multi-Dimensional Poverty Index

Dimensions	Indicators (house hold wise)	Weights
Health	At least one member is malnourished	1.67
	One or more children have died	1.67
Education	No one has completed five years of schooling	1.67
	At least one school-age child not enrolled in school	1.67
Condition of living	No electricity	0.56
	No access to clean drinking water	0.56
	No access to adequate sanitation	0.56
	House has dirt floor	0.56
	Household uses "dirty" cooking fuel (dung, firewood or charcoal)	0.56
	Household has no car and owns at most one of: bicycle, motorcycle, radio, refrigerator, telephone or television	0.56

Source: HDR 2010

Inequality-Adjusted HDI (IHDI)

Inequality adjusted HDI adjusts the HDI for inequality in distribution of the dimensions - life expectancy, years of schooling and household income or consumption - that exists across the age (life expectancy)

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and individual (schooling and income/ consumption). Adjusted means the inequality in each dimension is discounted from the average level of achievement in each dimension.

If HDI and IHDI are equal, it means there is no inequality. If IHDI is less than HDI, it means there is inequality.

Gender Inequality Index (GII)

Gender Inequality Index measures inequality that exists between men and women across three dimensions viz, reproductive health, empowerment and the labour market. To say more precisely, it reflects women's disadvantage in these dimensions. The indicators for reproductive health are Maternal Mortality Rate and Adolescent Fertility Rate (it is not applicable for men). The indicators for Empowerment are parliamentary representation and attainment at secondary and higher education. Labour market indicator is labour market participation.

GII ranges from 0 to 1. Zero represents fair equality and one represents very poor equality

Hybrid HDI

It is a different version of HDI. It applies the calculation method of New HDI for indicators of Old HDI. This enables the trend analysis of HDI.

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CHAPTER 4

POVERTY AND UNEMPLOYMENT

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CHAPTER 4

POVERTY AND UNEMPLOYMENT

In this Chapter, I will learn

- POVERTY
- ESTIMATION OF POVERTY IN INDIA
- UNEMPLOYMENT
- EMPLOYMENT AND UNEMPLOYMENT ESTIMATES
- TYPES OF UNEMPLOYMENT

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Poverty and unemployment are two major socio economic problems in most of the developing countries. As both have mutual cause and effect relationship, they are presented in the same chapter.

This chapter covers types of poverty, estimation of poverty in India, employment and unemployment estimates and types of unemployment.

POVERTY

Poverty can be defined as a social phenomenon in which a section of the society is unable to fulfill even its basic necessities of life. There are two types of poverty.

1. Absolute Poverty

2. Relative Poverty

1. Absolute Poverty

In this poverty, minimum physical quantities like cereals, pulses, milk, butter, etc are determined for a subsistence level of living and then the price quotations of these commodities are obtained from market to convert these commodity requirements into monetary terms.

By aggregating all the quantities included and its money value, a figure expressing per capita consumer expenditure is determined. The population whose level of income (or expenditure) is below this figure is considered to be Below the Poverty Line (BPL). It is expressed as number of poor people as a proportion of total population, say 10%. This measure is also called as head count ratio.

The reason to determine poverty on the basis of consumption expenditure instead of income is that dependent people like children and senior citizen also consume even though they are not earning. One more reason is even though income is less people may consume more with the backup of asset or by borrowing. It shows their ability to consume and have a descent standard of living. From this it is clear the consumption based measure is better than income based measure.

2. Relative Poverty

In this case, the income/consumption distribution of the population in different percentile groups is estimated and a comparison of the levels of living of the top 5 to 10 % with the bottom 5 to 10% of the population reflects the relative standards of poverty. Here a person's income/consumption may be above the poverty line but he happens to be poor in comparison with the person whose income/consumption is above his/her. This measure is to calculate inequality in the society.

The quintile income ratio is one of the measures of inequality. It is a ratio of the average income of richest 20 per cent of the population to that of the poorest 20 per cent.

Quintile Income Ratio = average income of richest 20 per cent / average income of poorest 20 per cent.

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ESTIMATION OF POVERTY IN INDIA

Dr. V.M. Dandekar and Nilkantha Rath

- After independence poverty estimation was carried out by Dr. V.M. Dandekar and Nilkantha Rath
- They fixed desired minimum level of per capita nutrition needed for subsistence level of living as 2,250 calories
- To purchase commodities that give 2250 calories for Rural ₹ 180 Per capita Per annum and for Urban ₹ 270 Per capita Per annum has been fixed at 1960 – 61 prices
- Using this cut-off, they stated that about 177 million were poor in 1960 – 61 and about 216 million in 1968 – 69

Planning Commission Expert Group Report

- The Planning Commission appointed an expert group named Task Force on Minimum needs and effective consumption demand
- It has been constituted in the year 1989
- Its Chairman was D.T. Lakdawala
- The expert group submitted its report in 1993
- Per capita daily intake requirement fixed at 2400 calories for Rural and for Urban at 2100 calories. The per capita requirement for rural area fixed has been high because of the hard physical labour they undergo
- A person who fails to have money to obtain this minimum level of calories is treated as being below the poverty line
- Different poverty line has been fixed for different states by taking into account, the variation in prices and consumption composition of commodities across various states
- Rural –consumer price Index for Agri-cultural Labourers (CPI-AL) was used for future update of rural poverty line
- Urban- consumer price Index for industrial Worker (CPI-IW) and Consumer Price Index for Urban non manual employee (CPI-UNME) was used for future update of urban poverty line

Table 4.1 Poverty ratio findings based on the methodology of this expert group

Year	1973–74	1993 -94	1999 – 2000
% of BPL People	54.9%	36%	26.1%

Source: Planning Commission

61st Round of National Sample Survey Organisation (NSSO) Survey and Poverty Estimation

This round of survey carried out during the period 2004-2005. It is a consumer expenditure survey. In this survey, people have been asked to recall and tell their expenditure of selected commodities for past 30 days and 365 days. From this data NSSO and planning commission used different methodology to estimate the incidence of poverty. This survey has fixed ₹356.30 and ₹538.60 as per capita monthly consumption expenditure as poverty line for Rural and Urban respectively.

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NSSO's Mixed Recall Period (MRP)

It involves estimation of poverty using consumer expenditure data of 365 days recall period for five infrequently purchased non-food items such as

i. Clothing
ii. Foot wear
iii. Durable goods
iv. Education
v. Institutional medical expenses, and a 30 day recall period for the remaining items.

Planning Commission's Uniform Recall Period (URP)

It involves estimation of poverty using consumer expenditure data of 30 days recall period for all items. It is well known that in India most of the non –food items are purchased only during festival period. So these expenditures may not figure during the survey period. Therefore the consumption expenditure during 30 days recall period will be lower than 365 days recall period expenditure and will inflate the figure of BPL families. It is evident from the table 4.2. To know the trend in the poverty we cannot compare estimation of poverty of NSSO and planning commission because of different methodology. But NSSO estimation of 1999-2000 is comparable with 2004-05 estimation and planning commission estimation of 1993-94 is comparable with 2004-05. So they have been juxtaposed.

Table 4.2 Poverty ratios by MRP and URP

Particulars	NSSO Mixed Recall Period (MRP)		Planning Commission Uniform Recall Period (URP)	
	1999 – 2000 55th Round	2004 -05 61st Round	1993 -94	2004 -05
1.In percentage (National)	26.1%	21.8%	36.0%	27.5%
i) Rural	27.1%	21.8%	37.3%	28.3%
ii) Urban	23.6%	21.7%	32.4%	25.7%
2. In absolute Term (National)	260 million	238.5 million	-	301.7 million
i) Rural	195 million	170.3 million	-	220.9 million
ii) Urban	65 million	68.2 million	-	80.8 million

Source: Planning commission

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Tendulkar Committee on Poverty

A committee named 'The Expert Group to Review the Methodology for Estimation of Poverty' headed by Suresh D. Tendulkar was formed by Planning commission in 2009. This committee adopted a new method. It moved from calorie based poverty estimation to nutrition, health and other expenditures like clothing footwear based estimation. It calls the basket of goods selected to determine poverty as Poverty Line Basket (PLB).

It also relies on the NSSO data of Mixed Recall Period Method. It calls to adopt urban poverty line for rural area also, after adjusting for price differential. It means the quantity of consumption fixed for both urban and rural is same, only the price differs. This committee fixed poverty ratio for All India total at 37.2 %, rural India at 41.8 % and urban India at 25.7 in the year 2004-05. The poverty line fixed for rural India is ₹ 446.68 and urban India is ₹ 578.80.

Rangarajan Committee on Poverty

There was lot of criticism about Tendulkar committee methodology. So government formed an Expert Technical Group to revisit the methodology for estimation of the poverty and identification of the poor under the chairmanship of Rangarajan. It adopted the method of calorie based methodology as in the past. In addition it accounted for nutrition, fat and other essential non food items to arrive at poverty line. It fixed Rs 972 per capita per month as poverty line for rural area and Rs 1181 for urban areas.

Ability to Pay Based Poverty Line

The author of this book in his article "Poverty Redefined"[1] published in Business Line on 2nd July of 2014 argues to fix poverty line at the level of Basic Exemption Limit (BEL) fixed for Income Tax purpose. This limit is fixed on the principle of ability to pay. The basic exemption limit is fixed at a level where the people are considered rich enough to part away their income for general cause in the form of tax. It means at that level a person is considered rich. So the author call to name people as poor whose income is below this limit.

The basic exemption limit is for individual. Even if a family has only one earning member he is charged to tax if his income is above this limit. So, the author calls to divide the BEL by five as the average family size in India is five which is the least tax exemption available for a family. For example if the BEL is Rs 2,00,000 the exemption available per person of a family of five is Rs 40,000 per year. This amount needs to be fixed as poverty line. It means Poverty Line needs to be fixed at 20 % of BEL.

UNEMPLOYMENT

Unemployment is a situation in which individuals are ready and willing to work

1 http://www.thehindubusinessline.com/opinion/poverty-redefined/article6167218.ece

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at the prevailing rate of wages but the individuals could not get work.

Number of unemployed = Labour force - Work force

EMPLOYMENT AND UNEMPLOYMENT ESTIMATES

As per the NSSO, here are the concepts and definitions of employment and unemployment estimates.[2]

Activity Status

It is the activity situation in which a person is found during a reference period, which concerns the person's participation in economic and non-economic activities. According to this, a person will be in one or a combination of the following three statuses during a reference period.

- Working or being engaged in economic activity (work)
- Being not engaged in economic activity (work) and either making tangible efforts to seek 'work' or being available for 'work' if the 'work' is available and
- Being not engaged in any economic activity (work) and also not available for 'work'.

Persons in the categories (1) and (2) above are called **labour force**.

Persons in the category (1) are called employed. They also termed as **work force**.

2 Instructions guide to field staff-volume I, Designs, Concepts, Definitions and Procedures. NSSO 64th Round, July 2007-June 2008

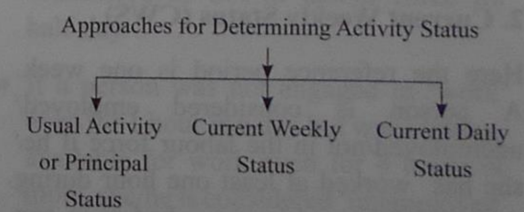
Persons in the category (2) are called **unemployed**.

Persons in the category (3) are termed as **not in the labour force**.

Different Approaches for Determining Activity Status

The people surveyed are to be classified into various activity categories on the basis of activities pursued by them during certain specified reference periods. There are three periods for this survey viz. (1) one year, (2) one week and (3) each day of the reference week. Based on these three periods, three different measures of activity status are arrived. These are termed respectively as usual status, current weekly status and current daily status. It is shown in the figure 4.1. The activity status determined on the basis of the reference period of 1 year is known as the Usual Activity Status (US) of a person, that determined on the basis of a reference period of 1 week is known as the Current Weekly Status (CWS) of the person and the activity status determined on the basis of each day of the reference week is known as the Current Daily Status (CDS) of the person.

Fig 4.1



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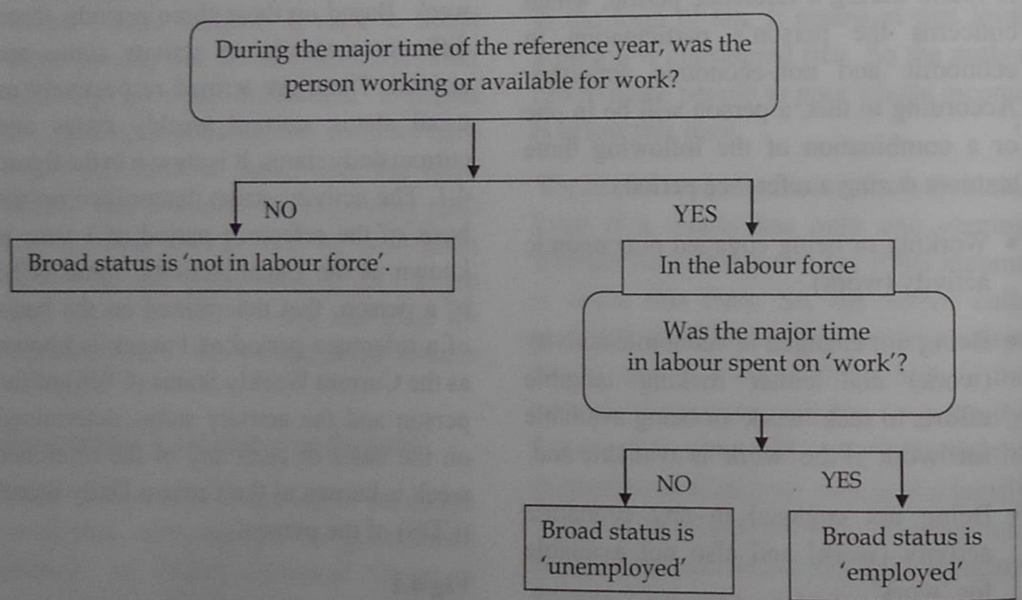
1. Chronic or "Usual principal Status" (US)

Here, the reference period is one year. It is measured in number of persons, that is, persons who remained employed/ unemployed for a major part of the year. A person is considered employed/ unemployed/not in the labour force if she/ he was working/not working but was either seeking or was available for work/not working and also not available for work for a relatively longer time throughout the reference year. This can be understood by flowchart 4.1. Here, we classify persons into number of employed, and unemployed and not in the labour force category and we do not measure the intensity of employment or unemployment. This measure is more appropriate to those in search of regular employment, e.g. educated and skilled persons. The estimates are made in terms of the average number of persons per year in each activity statuses, say 10 million persons/year.

Flow Chart 4.1



2. Current Weekly Status (CWS)

Here the reference period is one week. A person is considered employed/ unemployed/not in the labour force if he/ she has worked at least one hour during the reference week/ not worked even one hour but was seeking or was available for work/ not working and also not available for work. This can be understood by flow chart 4.2 in the next page. If a person is employed even for an hour in a week, he is considered employed. Here we just classify persons into number of employed and unemployed category and we do not measure the intensity of employment or unemployment. The estimates are made in terms of the average number of persons per week in each activity statuses; say 10 million persons/week.

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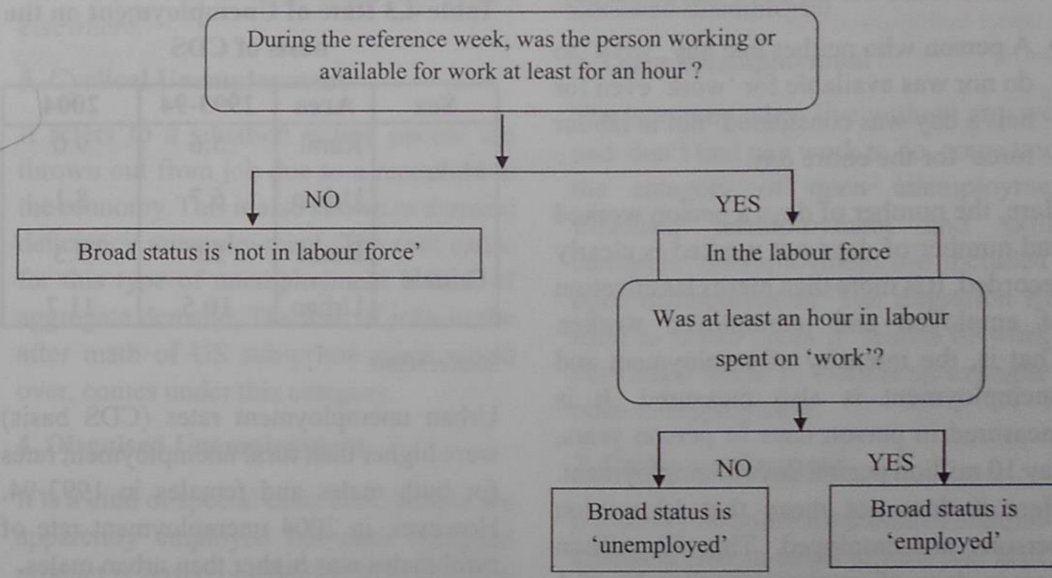
Flow Chart 4.2



3. Current Daily Status (CDS)

Here also, the reference period is one week like Current Weekly Status. It records the activity status of a person for each day in the seven days preceding the week of survey.

- Each day of the reference week is looked upon as consisting of either two 'half days' or a 'full day' for assigning the activity status.
- A person is considered 'working' (employed) for the entire day if she/he had worked for 4 hours or more during the day.
- If the person had worked for 1 hour or more but less than 4 hours, she/he is considered 'working' (employed) for half-day.
- In the balance half-day if seeking or available for work', she/he is considered as unemployed for half-day. If 'neither seeking nor available for work' then considered as not in labour force for half-day.
- If a person was not engaged in 'work' even for 1 hour in a day but was seeking/ available for work even for 4 hours or more, she/he is considered 'unemployed' for the entire day.

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- If a person was 'seeking/available for work' for more than 1 hour and less than 4 hours only, she/he is considered 'unemployed' for half day and 'not in labour force' for the other half of the day.
- A person who neither had any 'work' to do nor was available for 'work' even for half a day was considered 'not in labour force' for the entire day.

Here, the number of days a person worked and number of days not worked is clearly recorded. It is more than mere classification of employed and unemployed worker. That is, the intensity of employment and unemployment is also measured. It is measured in person days or person years, say 10 million person days of employment. Here it does not mean that 10 million persons are employed. This 10 million person days of employment may be of 1 lakh workers for 100 days (1 lakh x 100 = 10 million).

It is considered to be a comprehensive measure of unemployment, as it captures chronic unemployment as well as under employment on weekly basis.

Salient Features of 60th Round of NSSO Survey on Employment and Unemployment Survey Conducted in January –June 2004.

The unemployment rate went up between 1993-94 and 2004. It is clear from the table 4.3.

Unemployment rates on the basis of current daily status were much higher than those on the basis of Usual status implying a high degree of intermittent unemployment. This could be mainly due to the absence of regular employment for many workers.

Table 4.3 Rate of Unemployment on the basis of CDS

Sex	Area	1993-94	2004
Male	Rural	5.6	9.0
	Urban	6.7	8.1
Female	Rural	5.6	9.3
	Urban	10.5	11.7

Source: NSSO

Urban unemployment rates (CDS basis) were higher than rural unemployment rates for both males and females in 1993-94. However, in 2004 unemployment rate of rural males was higher than urban males.

Unemployment rates varied sharply across states. States where wages are higher than neighbouring ones because of strong bargains or social security provisions such as high minimum wage, had high incidence of unemployment in general.

TYPES OF UNEMPLOYMENT

1. Structural Unemployment

It is the unemployment caused by structural changes like rapidly growing population; fall in the rate of capital formation; technological change etc., in the economy. It is of long run nature.

2. Frictional Unemployment

It occurs when people change from one job

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to another and remain unemployed during this interval period .This can happen even in a situation of full employment. In order to avoid this usually people resign the current job only after getting employment elsewhere.

3. Cyclical Unemployment

It refers to a situation where people are thrown out from job due to a recession in the economy. This is also known as demand deficiency unemployment. The root cause for this type of unemployment is lack of aggregate demand. The loss of jobs in the after math of US sub-prime crisis world over, comes under this category.

4. Disguised Unemployment

It is a kind of special case. Here people are apparently employed but their marginal product is zero (contribution to production is nil). Marginal product means the produce added to the existing production due to addition of a new employee/worker. For example, if 4 persons are employed in a factory and they produce 17 units and fifth person is added and the produce increased to 19 units, the additional 2 units (19 minus 17) is marginal product. Here, we can consider the fifth person as employed. Suppose, if there is no increase in production, the marginal product is zero and he is disguisedly unemployed. Even if she/he is removed from the activity, there will be no decline in production. This type of unemployment is a feature of Indian agriculture.

5. Educated Unemployment

Even a person who is educated/ trained and skilled, fails to obtain a suitable job suited to his qualification, he is said to be educated unemployed.

6. Open Unemployment

The labourers when live without any work and don't find any work to do come under the category of open unemployment. Educated unemployment and skilled labourers' unemployment are included in open unemployment. The migration from rural to urban areas in search of work is very often found in India is an example of open unemployment.

7. Under employment

It refers to the underutilization of manpower available both in terms of time and skill. If a post graduate of engineering works as a clerk or an office assistant in an office, he is underutilised in terms of manpower. Consider a situation of a person with right qualification in a right job but not engaged in that work the whole time for which he is available then that person is under utilised in terms of time.

8. Voluntary Unemployment

Though jobs are available some person may want to remain idle come under the category of this kind. The people who consider themselves rich enough and think that they are not in the need to work; people who do not have the mind set to work regardless of their economy position and

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lazy people are included in this category. These people are not in the labour force.

9. Natural Unemployment

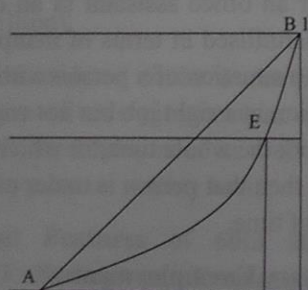
Unemployment ranging between 2 to 3% in the country is considered natural and inevitable. This minimal percentage of unemployment cannot be eliminated at all. It is called natural unemployment.

RELATED TERMS

Lorenz curve

Lorenz curve is curve maps the relationship between the percentage of income or wealth earned or appropriated and percentage of people earned that particular percentage of income or wealth. The cumulative percentage of income is measured on the Y axis and the cumulative percentage of people is measure on X axis.

Fig 4.2



In the figure the AB is the line of equality. The line AEB is Lorenz curve. It is the line of inequality. The point E, shows that 90 % of people earns 60 % of income and the remaining 10 % of people earns the remaining 40 % of income. It shows that there is inequality.

Gini coefficient

Gini coefficient measures the inequality using Lorenz curve. It is the ratio between area above the Lorenz curve and area below the Lorenz curve.

Gini coefficient = Area above Lorenz curve / Area below Lorenz curve

The area above Lorenz curve is the area between Lorenz curve and line of equality. The area below Lorenz curve is the area between Lorenz curve and axis of the graph.

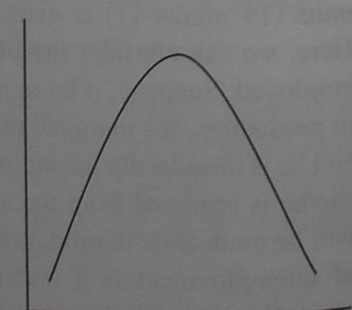
In the above graph,

Gini coefficient = AEB/AECB

Kuznets Curve

The Kuznet curve says that in a developing economy initially the inequality will increase and with increase in growth the inequality will come down. This was said by economist Simon Kuznets. It is a bell shaped curve. It is shown in the Figure 4.3.

Fig 4.3



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Engel's law

Ernst Engel said that with the increase in income the proportion of expenditure spent on food falls down. But there may be an increase in the absolute amount spent on food. For example when the income is Rs 3,000 per month the family may spend Rs 1500 on food. It is 50% of income. But when the income rises to Rs 10,000 the family may spend Rs 3,500 on food. In absolute term there is an increase of Rs 2000 but in percentage term it is only 35 % of total income. So the proportion spent on food came down from 50 % to 35 %.

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CHAPTER 5

PUBLIC FINANCE

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CHAPTER 5

PUBLIC FINANCE

In this Chapter, I will learn

- GENERAL BUDGET
- RECEIPTS
- EXPENDITURES
- TYPES OF DEFICIT
- TYPES OF BUDGET
- TAX
- CLASSIFICATION OF TAXATION
- METHODS OF TAXATION ON GOODS
- TYPES OF TAXES
- FRBM ACT 2003
- TAX REGIMES OF CENTRE & STATE
- RELATED TERMS

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Public Finance is one of the disciplines in economics that deals with resource mobilisation for and utilisation of the same to accomplish State activities at all levels viz., central, state and local governments.

This chapter covers general budget, types of deficit, types of budget, tax, additional terms related to tax, Fiscal Responsibility and Budget Management (FRBM) Act and tax regime of Centre and State.

GENERAL BUDGET

Budget is an annual financial statement. In case of central government Article 112 and in case of state government Article 202 of the Indian constitution requires the annual financial statement to be laid before the respective legislatures. The budget is a statement of accounts of Government.

Pranab Mukherjee observes:"The Union Budget cannot be a mere statement of Government accounts. It has to reflect the Government's vision and signal the policies to come in future."[1] So it is more than just a financial statement.

Railway budget was separated from General Budget in 1921 on the recommendation of "Acworth Committee". Aggregates of receipts and expenditure of the railways are incorporated in the General Budget. Demand for Grants relating to railway expenditure is presented to Parliament separately in advance of the general budget. Demand for Grants is a statement of estimates estimated expenditure to be made out of Consolidated Fund of India. It is required to be voted by Lok Sabha.

General budget contains estimated receipts and expenditure for one year usually.

i. Actual figure of the previous year

ii. Budget and Revised figure for the current year

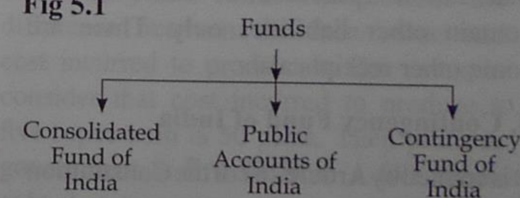
iii. Budget estimate for the upcoming year

Budget estimates are based on the previous two year estimates.

If it is the budget of 2009-10, the previous year is 2007-08 the current year is 2008-09 and the coming year is 2009-10. Here a confusion may arise regarding the years mentioned. You may raise the question how 2008-09 will become current year for 2009-10 budget. Please remember that the budget for 2009-10 is submitted at the end the fiscal year 2008-09. So it becomes the current year. Accordingly other years also come to be mentioned.

The estimated receipts and expenditures are essentially made into and out of following funds. They are shown in the figure 5.1.

Fig 5.1



1. Consolidated Fund of India

The Consolidated Fund has been defined in Article 266 (1) of the Constitution.

1 Budget speech 2010-11

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According to the same, all revenues received by the Government of India, all loans raised by that Government by the issue of treasury bills, loans or ways and means advances and all moneys received by that Government in repayment of loans shall form one consolidated fund to be entitled "The Consolidated Fund of India".[2]

All expenditure incurred by the Government including repayment of debt and loans given to States/UT Governments is spent out of this Fund.

2. Public Accounts of India

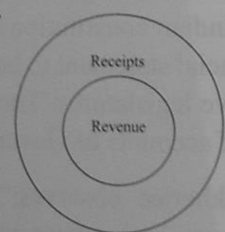
It is established under Article 266 (2) of the Constitution. All public money received other than those included in Consolidated Fund of India are held in Public Accounts of India. This account mainly consists of money raised through small saving schemes, provident fund schemes etc. Government is just custodian of these. It has to repay either on maturity date or whenever claimed by people. This kind of debt or obligation raised by government is called other liabilities. But it is to be noted that Public Accounts of India doesn't contain other liabilities only. There are some other receipts also.

3. Contingency Fund of India

It is created by Article 267 of the Constitution to meet unforeseen expenditure. It is held at the disposal of Honourable President of India. He/she can meet the expenditure and get the approval of parliament later.

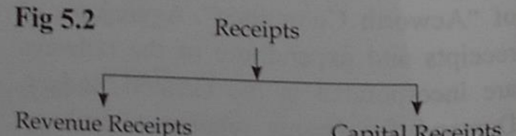
RECEIPTS

Before getting into the details of receipts it is necessary to see the difference between receipts and revenue. Revenue belongs to the receiver. It need not be repaid by the receiver. If we take an individual the salary received by him is his revenue. Receipts include revenue apart from others. For example loan received also included in receipts. The loan received needs to be repaid. The figure 5.2 explains this relationship.



As per Articles 112 and 202 of Indian constitution it is necessary to distinguish revenue expenditure from other expenditure. In addition to this classification Indian budget classifies receipts also alike.

Fig 5.2



A. Revenue Receipts

Revenue receipts are those receipts which need not to be paid again to the payee by government and income from government assets. These are necessarily one way transaction i.e no need to return the receipts and it is a onetime settlement. Revenue receipts are three types:

1. Tax Revenues
2. Non – tax Revenues
3. Other non-tax receipts

1. Tax Revenues

The revenue generated by levy and collection of taxes by central government is called tax revenue.

i. Union Excise Duties

It is the tax on production of commodities.

ii. Customs Duties

It is the tax on export and import of commodities from and to the country.

iii. Corporate Tax

It is levied on the company's profit income. There is no any separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown in separate head.

iv. Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firm etc.

v. Service Tax

It is a tax on the services consumed by consumers.

vi. Taxes of Union Territories

In India, Union Territories [except Delhi and Puducherry] are under the direct administration of the Centre. So their tax income is lumped and taken into account in the central budget.

vii. Other Taxes and Duties

Tax income from other taxes like wealth taxes are lumped together under this category.

2. Non Tax Revenues

i. Interest Receipts

It is the interest income from the loans given by the central government to state governments and other government bodies.

ii. Dividends and Profits

Dividends are income from the shares held by governments in private enterprises and semi government enterprises. Profits are dividend income from the fully government owned enterprises.

3. Other Non-Tax Receipts

i. Fiscal Services

a) Currency, Coinage, Mint

These are profit from the circulation of currency and coins. The profit is the difference between the face value and cost incurred to produce it. For example consider that cost incurred to produce a five rupee coin is 50 paisa. Then profit to government is ₹ 4.50 from a five rupee coin.

b) Other Fiscal Services

These receipts mainly consist of amount paid by RBI towards international

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2 Control over Public Finance in India S.P.Ganguly, Second revised edition, 2006 p.39

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obligations like subscriptions to international bodies and penalties charged by international financial bodies.

ii. Other General Services

Receipts from public services commission, central police etc are included in this category.

iii. Social services

Receipts from departments like education, sports, culture, health, information and publicity etc constitute this category.

iv. Economic services

Receipts of departments like Agriculture and allied activities, irrigation and flood control, energy, transport and communication come under this category.

v. Grants in Aid Contributions

These are receipts from foreign governments and multilateral bodies as gift to the government which need not be repaid. It also includes contribution in the form of material and equipment.

4. Non tax Receipts of Union Territories

Revenues that have been raised in the form of fees, fines etc. within the union territories and from sale of timber and forest produce in Andaman and Nicobar Islands are put under this category.

B. Capital Receipts

These receipts are essentially a two way transactions. It means once disbursed money will come in the form regular income or at the time disposal if any asset was created out of the disbursed money. These receipts can be raised either from already invested amount in the form of loan given /asset created by disposing it or on the assurance that it will be paid back in future if government has not invested already and has no claim over the source of this receipt. In short, they are:

a. Receipts due to disposal of permanent assets

b. Recovery of Loans given to others

c. Fresh loans raised by the government

Capital receipts can be classified into two categories as shown below.

1. Debt capital receipts
2. Non-debt capital receipts

1. Debt capital receipts

Among the above listed capital receipts fresh loans raised (borrowings) by the government along with other liabilities fall under this category. In short

I. Borrowing

II. Other liabilities

I. Borrowings

Borrowings or public debts are money raised on the security of consolidated fund of India and repayable out of it. The borrowings are of two types as under:

A. Internal borrowings

B. External borrowings

A. Internal Borrowings

Money borrowed within the country from

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various sources and various instruments is called internal borrowing.

a. Market Loans (net)

Net market loans = Gross market loans - Repayment of old loans

Market loans are raised by issuing bonds (dated securities) to public and financial institutions. They have maturity of 12 months or more. They are generally interest bearing with fixed "coupon" (i.e., periodic interest payment). But after 1992-93 the fixed interest system has been changed and became flexible.

b. Treasury Bills Issued to RBI & Banks

Treasury bills are securities issued by Government treasury. They are of short term nature and in this regard they differ from market loans. They are non-interest bearing (zero interest / zero coupons). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. It means security worth of ₹ 1,000 is issued against receipt of amount lower than ₹ 1000. The purchaser of security can redeem the full ₹ 1,000 at a particular date. This is called redeem at par (original value).

There are number of Treasury bills of differing maturity. Till 1991-92 there were only 91 days Treasury bills. It is also called as ad-hoc Treasury bill. It was discontinued from 1997-98. In its place ways and means advance came to be introduced. In 1998-99, 182 days Treasury bills were introduced. But it was replaced by 364 days Treasury bills. Again 182 days treasury bills were reintroduced. 14 days Treasury bills were introduced in 1999-2000.

c. Other Internal Debt

Debt raised to meet budget needs apart from the previous two methods are called other internal debt.

i. Funded Securities

Sometimes short term treasury bills are converted as market loans (long term loans) to defer the repayment. These are called funded securities. And these were made as non-marketable. Sometimes portion of these securities was made marketable. Non-marketable means it cannot be sold to any third party.

ii. Other Special Securities Issued to RBI

Bonds issued by the government to raise funds which were outside its annual borrowing programme like oil bonds, fertiliser bonds were classified as special securities. If these bonds were subscribed by RBI come to be accounted in this head.

iii. Ways and Means Advance

RBI acts as banker to the government. It keeps the bank account of Government. It receives and pays money on behalf of government. If the balance goes negative RBI lends short term interest bearing advance to government. It is called ways and means advance. It is like overdraft facility available to government from RBI, like over draft facility available to current account holders in commercial banks.

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iv. Special Floating and Other Loans

Special loan schemes are launched to raise money and their interest is subject to revision periodically, based on some pre-defined variables. These are called special floating. Such a scheme was launched in 2001-02.

v. Securities against Small Savings

In 1999-00 government of India created a fund called National small saving fund in the Public accounts of India. Barring state provident funds, insurance and Pension funds, Trusts and Endowments, and some small saving funds, all other savings are credited to this fund. Out of this fund 20% of amount is invested in central government securities subject to some conditions. These are called securities against small savings.

vi. Compensation Bonds and Others

Compensation bonds are bonds issued by the government to affected persons by its policy decision. For example, government abolished Zamindari system; to compensate their loss the government issued bonds. These bonds were made to be converted as money in future date. These bonds are of usually long term nature.

vii. Non-negotiable, Non-interest Bearing Securities Issued to International Financial Institutions

These securities issued to international financial institutions like World Bank, Asian Development bank etc. Non-negotiable means they cannot be sold to others by security holders and can be redeemed from issuing authority only.

B. External Borrowings

Money borrowed from outside the country from various sources and instruments is called external borrowing. They are classified as multilateral and bilateral loans.

a. Multilateral Loans

These are loans received from multilateral agencies like IMF, World Bank. Unlike Non-negotiable, non-interest bearing securities issued to international financial institutions these are borrowed not against securities.

b. Bilateral Loans

These are loans raised from foreign governments and foreign government bodies directly.

II. Other Liabilities

Liability literally means the responsibility to pay money or responsible for something. Other liabilities in Indian official context are money not borrowed directly from people but available for government's expenditure purpose. They are money deposited in the custody of government by public. The government uses this money for socio-economic development. So the government is liable to repay. This money is kept in the Public Accounts of India and paid out of it whenever claimed. They are

A. Small Saving Scheme

B. Provident Funds

C. Other Accounts

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A. Small Saving Scheme

It includes all small savings prior to the creation of NSSF (National Saving Scheme Fund) and those small savings not credited into NSSF.

B. Provident Funds

It includes General (public) Provident Funds (GPF) and state provident funds prior to the creation of NSSF and only general public provident fund thereafter.

C. Other Accounts

a. Deposits of non-government provident funds etc

Deposits of Employees Provident Fund (EPF) of non-government sector are included in this category.

b. Other items

This includes securities issued to nationalised banks, oil companies and others.

D. Reserve Funds of the Railways, Posts and Telegraphs

These are funds created by these departments to iron out excessive variations, undue fluctuations in revenues by using it as a buffer stock. Other funds like depreciation funds, railway safety funds are also included in this category.

These budget liabilities are taken into account while calculating deficits of the government budget if they are drawn from Public Accounts for the purpose of government expenditure.

2. Non-debt capital receipts

Amounts received by the government from disposal of its assets (except public sector assets which will be credited to the National Investment Fund) and recovery of loan given to others are included in this. They can be listed as:

i. Recoveries of Loans

ii. Disinvestment of government shares other than PSUs (Public Sector Units)

National investment fund is a fund created by government to deposit the proceeds from disinvestment of PSUs.

After restructuring of the National Investment Fund (NIF) on 17th January, 2013 the disinvestment proceeds with effect from the fiscal year 2013-14 is credited to the existing 'Public Account' under the head NIF and they would remain there until withdrawn/invested for the approved purpose. It was decided that the NIF would be utilized for the following purposes:

a. Subscribing to the shares being issued by the CPSE including PSBs and Public Sector Insurance Companies, on rights basis so as to ensure 51% ownership of the Government in those CPSEs/PSBs/ Insurance Companies, is not diluted.

b. Preferential allotment of shares of the CPSE to promoters as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 so that Government shareholding does not go down below 51% in all cases where the CPSE is going

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to raise fresh equity to meet its Capex programme.

c. Recapitalization of public sector banks and public sector insurance companies.

d. Investment by Government in RRBs/ IIFCL/NABARD/Exim Bank;

e. Equity infusion in various Metro projects;

f. Investment in Bhartiya Nabhikiya Vidyut Nigam Limited and Uranium Corporation of India Ltd.;

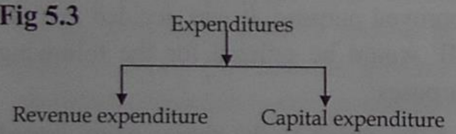
g. Investment in Indian Railways towards capital expenditure

The allocations out of the NIF will be decided in the Government Budget.[3]

EXPENDITURES

The public expenditure can be classified as shown in the figure.

Fig 5.3



A. Revenue Expenditure

Expenditure incurred to meet day to day and regular needs expenditure of government and that will not yield any revenue in future are termed as revenue expenditure. It is a one way payment. It means if government spends money it cannot recover it. These are

3 http://www.divest.nic.in/Nat_inves_fund.asp

1. Interest Payments

Interest paid on borrowing and other liabilities and discounts on treasury bills do constitute this category.

2. Defence, Police

Expenditure towards law and order come under this head. Though defence equipments are capital in nature considered as revenue expenditure. But all the defence equipments are not in revenue expenditure nature.

3. Subsidies

Subsidies on public distribution, fertilisers etc. are included in this category.

4. Grants to States & Union Territories

Grants given by Centre to states and union territories come under this head. Though these grants are spent under capital expenditure by receiving governments come under this head as stipulated by Article 34(c) of the Audit Code.

5. Pensions and Salaries

Pensions and salaries of central government departments, and those paid out of consolidated as charged expenditure come under this category. Charged expenditure means the expenditures that can be spent without vote (approval) of legislature.

6. Economic Services

Non capital Expenditure towards Agriculture, Industry, Power, Transport, Communication etc are included in this item.

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7. Other General Services

Non capital Expenditure towards Organs of States, tax collection external affairs etc are included in this item.

8. Social Services

Non capital Expenditure towards Education, Health, Broad casting etc.,is included in this item.

9. Postal Deficit

Postal department is unable to meets its expenditure out of its own revenue. This short fall crosses ₹ 1,000 Crores. This is met by central government.

10. Expenditure on Union Territories without Legislatures

Expenditure towards administration and other expenditure on Union Territories without legislatures come under this item.

11. Grants to Foreign Governments

Grants given to foreign governments like Bhutan, Nepal, and some other developing countries towards their developmental expenditure and aid given during disaster, natural calamities to all foreign countries constitute this category.

B. Capital Expenditure

In general expenditures that create permanent assets and yield periodical income and loans given to state governments and local bodies are called capital expenditure. It is a two way payment. It means spent money can be recovered through periodical income and/ or by disposal of asset created.

In addition as per Article 34 of the Audit Code, the following considerations are relevant in arriving at a decision whether or not expenditure is of capital nature.[4]

(a) It is not essential that the concrete assets should be productive in character or that they should even be revenue producing. A productive asset may be considered as one which produces sufficient revenue to afford a surplus over all charges relevant to its functioning. It may on rare occasions be necessary and justifiable to treat as a capital scheme not commercially remunerative but involving large expenditure, say for construction of a new city.

(b) The purpose of commutation of recurring liabilities is their extinction or reduction. Although expenditure on this purpose may be genuinely capital expenditure, it is always necessary to examine from the point of view of economic financial administration whether such capital expenditure does not in fact merely replace one set of recurring payment by another, for example, where commutation by debit to capital of pension payment does not result in the substitution of equivalent payments of interest.

(c) It is inherent in the definition of capital expenditure that the assets produced should belong to the authority incurring the expenditure. Expenditure by Government

4 Control over Public Finance in India S.P.Ganguly, Second revised edition 2006 p.47

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on grants-in-aid to local bodies or institutions for the purpose of constructing assets which will belong to these local bodies cannot legitimately be considered as capital expenditure.

(d) Expenditure on a temporary asset cannot ordinarily be considered as expenditure of a capital nature.

Plan and Non-Plan Expenditure*

Before the setting up of NITI Aayog, India was following planned development through 5 year planning. So in the plan, the expenditure came to be classified as plan and non-plan expenditure.

Plan Expenditure

Expenditures envisaged in 5 year plan documents are called as Plan Expenditure. It has both revenue and capital component like expenditure on Central Plan.

Non-Plan Expenditure

Expenditures not envisaged in the 5 year plan documents are called as Non Plan Expenditure. It also has both revenue and capital component of expenditure.

DEFICIT

Deficit means shortage. Here deficit means shortage of money for expenditure. The gap between the receipts and expenditure is called deficit. There are various types of deficits which are explained below. (In the case of equations, you just keep in mind the words in italics. The words in normal letters are to make its components in detail).

* *Italics: This may not be relevant in the context of NITI Aayog. However, for the purpose of conceptual clarity the topic is given*

Budget Deficit

It is the difference between Total Expenditure and Total Receipts. Budget deficit is always zero. It doesn't have any meaning in central government budget. So

Budget Deficit = Total Expenditure – Total Receipts

= (Capital expenditure + Revenue expenditure) – (Capital Receipts + Revenue Receipts)

= (Capital expenditure + Revenue expenditure) – {(Borrowings and other liabilities + Receipts other than Borrowing) + (Revenue Receipts)}

Revenue Deficit

Revenue deficit is the difference between revenue expenditure and revenue receipts.

Revenue Deficit = (Revenue Expenditure – Revenue Receipts)

Or

= *[Current Revenue Expenditure – Current Revenue Receipts]*

Fiscal Deficit

Fiscal Deficit is the difference between Total Expenditure and Total Receipts except Borrowing and Other liabilities.

Fiscal Deficit = Total Expenditure – Total Receipts except Borrowing and Other liabilities

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= *Total Expenditure –[Capital Receipts other than Borrowings and other Liabilities + Revenue Receipts]*

= Budget Deficit + [Borrowing from RBI + Public borrowing and other liabilities]

To be precise about fiscal deficit it is the amount of *Borrowing and other Liabilities.*

Primary Deficit

Primary Deficit is measured by subtracting the interest payments from fiscal deficit. It is a measure of current year's fiscal operation after excluding the liability of interest payment created due to borrowings under taken in the past.

Primary Deficit = Fiscal Deficit – Interest Payment

Monetised Deficit

Monetised deficit goes beyond the Government budgetary operations. This represents increase in the net RBI credit to the Union Government which is the sum of increases in the RBI's holding of Government debt plus any draw down by the Government of its cash balance with RBI. To say simply, the monetised deficit represents the expansion in money by the RBI.

Monetised Deficit = Borrowing from RBI + Draw down balance of government from RBI

TYPES OF BUDGET

There are different kinds of budget. These budgets have different principle to achieve best results. They are explained in the following passage.

Performance and Programme Budgeting

In this budget the chosen programmes/ projects are subjected to the tests of actual performance against their expected standards. So it involves stage wise plan and standard fixation to assess performance of programmes. It establishes a correlation between physical (output) & financial (input) aspects of each programme and activity.

It was introduced in India in 1968 for 4 ministries and in 1975 – 76 for all developmental departments.

Outcome Budget

It is the compilation of anticipated and intended outcomes of various ministries. Outcome is not just the physical output of financial input. Outcome means the benefits arise out of physical output from respective financial input. For example if 'n 'number dams constructed out of allocated money it is physical output. The rise in the productivity of fields getting irrigation facility form these dams and resultant increase in the income of farmers etc is Outcome. 1st outcome Budget was introduced in August 25, 2005.

Zero based Budget

In this budgeting all the schemes and programmes are not included in every year budget just for the reason being that they already exist. Under it every

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scheme should be reviewed critically and re-justified that why they have to be included in the coming budget. It involves a consideration that there is no existing schemes/programmes and the budget has to be started from scratch/ zero base. So it is called as Zero based Budget. Finance ministry has the plan to introduce it in future.

TAX

Tax is a compulsory levy payable by an economic unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government. Quid pro quo means something given or taken equivalent to another.

Broad Areas of tax

a. Tax on income and expenditure

Taxes imposed on Personal income, Corporate income, Sales tax and like come under this area.

b. Tax on commodities

Taxes like Excise duty, Custom duty fall under this category.

c. Tax on Property & Property Transaction

Taxes like wealth tax, Estate & Succession duties are classified under this category.

Tax Base

Tax base is the legal description of the object with reference to which the tax is payable. It may have time dimension like year, month.

E.g. Base of excise duty is production of commodities.

Base of income tax is income of individual.

Tax Buoyancy

It measures actual or observed change in Tax revenue relative to GDP.

Tax Buoyancy = Proportionate change in the tax revenue/Proportionate change in GDP

Tax Buoyancy = $\%\Delta T/\ \%\Delta GDP$

Where,

ΔT = Change in Tax revenue

ΔGDP = Change in Gross Domestic Product

Here, the change in the tax can be for two reasons one is due toautomatic increase and another one is due to discretionary changes that is change in tax rate or coverage or both.

Change in tax rate will lead to change in tax revenue. Change in coverage means bringing new group of economic units (tax base) into or leaving existing groups out of taxation. The introduction of negative list in service tax is an example for this. The negative list system brought all the services into service tax net except services listed in the negative list.

Tax Elasticity

Proportionate change in tax revenue, without any discretionary change, relative

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to GDP is called tax elasticity. Tax revenue that is calculated after setting aside the change in tax revenue due to discretionary changes is called adjusted tax revenue.

Tax Elasticity = Proportionate change in Adjusted tax revenue/Proportionate change in GDP

Tax Elasticity = $\%\Delta AT/\%\Delta GDP$

Where,

ΔAT = Change in Adjusted Tax revenue

ΔGDP = Change in Gross Domestic Product

Example,

Total change in tax revenueis 20%. Out of this, change in tax revenue automatically is 10% and due to discretionary changes like change in tax rate is 10 %.

Change in GDP is 10 %. Then

Tax Buoyancy = 20/10 = 2

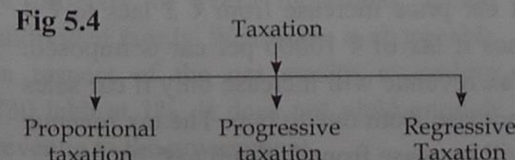
Tax Elasticity = 10/10 = 1

These measures help in forecasting the tax revenue and in deciding the policy regarding tax rate and coverage to achieve targeted tax revenue.

CLASSIFICATION OF TAXATION

The taxation can be classified mainly into three types as shown in the figure 5.4.

Fig 5.4



Proportional Taxation

Tax levied as a % of tax base irrespective of size of tax base, at a uniform rate is called as proportional tax. For example both who receive income/spend/purchase worth of ₹10,000 and ₹100,000 pay equal % of tax.

Table 5.1

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	10%	₹ 10,000

Here the % of tax rate remain the same but the absolute amount of tax increases with increase in size of tax base.

Progressive Taxation

If tax rate increase with the increase in size of tax base, it is called progressive tax. For example, those who receive income/spend/purchase worth of ₹ 100,000 pay higher tax rate than those of ₹ 10,000.

Progressive taxation helps to ensure economic equality in the society.

Table 5.2

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	20%	₹ 20,000

Here the % of tax rate as well as the absolute amount of tax increases with increase in size of tax base.

Regressive Taxation

If tax rate decrease with the increase in the

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tax base it is called regressive tax. Here those who receive income/spend/purchase worth of ₹ 100,000 pay lesser tax rate than that of ₹ 10,000.

Table 5.3

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	5%	₹ 5,000

Here the % of tax rate decrease but the absolute amount of tax increases with increase in size of tax base but less than that of proportional and progressive taxation.

Impact of Tax

Impact of a tax is on its first point of contact with the tax payers. It is upon those who bear the first responsibility of paying it to the authorities. In case of Income Tax it is income recipient. In case of Sales Tax it is Seller.

Incidence of Tax

Incidence of a tax is on its final resting place, i.e. those economic units which finally bear the money burden of tax, and which are not able to pass it to others. In case of income tax, it is the income recipient who has to bear the money burden of paying tax. In case of Sales tax, tax is paid by seller but ultimately paid by consumer along with price. Here the seller acts as an intermediate between government and consumer by collecting tax along with price. While the seller can pass the tax burden to the consumer, the consumer cannot. So the seller is point of impact and consumer is point of incidence.

Effects of Tax

When a tax is imposed and collected, it elicits certain responses from tax payer which have influence on working hours, saving, investment etc. Such responses and their results are called Effects. For example, if heavy tax is imposed on spending, people will save more to avoid tax burden.

METHODS OF TAXATION ON GOODS

1. Ad valorem

If tax is levied as a % of the value of the goods regardless of number of units produced/sold/imported, then it is called ad valorem e.g. 10% on the value of car. Revenue increases with rise in price. Let us take an example. If price of the car is ₹ 2 lacs, the tax amount is ₹ 20000 and if the car price increase to ₹ 4 lacs the tax amount is ₹ 40000.

2. Specific duty

If tax is levied at a flat rate per unit of goods produced/sold/imported regardless of the value then it is called specific duty. E.g. ₹ 2 per 1kg of iron, ₹ 3 per 1mt of cloth. Revenue increases only with number of units not with value. Let us take the above example: the tax amount will not increase if car price increase from ₹ 2 lacs to ₹ 4 lacs if tax of ₹ 10000 per car is imposed. Tax revenue will increase only if car sales increase from one to two. The tax revenue will increase from ₹ 10000 to ₹ 20000.

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In some cases, both type of tax is levied on the same good, e.g. ₹ 10,000 per car plus 10% on the value of car.

TYPES OF TAXES

There are two types of taxes namely

1. Direct Tax
2. Indirect tax

1. Direct Taxes

If the impact and incidence lies on same point it is called as direct tax. E.g. income tax levied on 'X' person paid by the same 'X' person.

Direct taxes are progressive in nature in India and all over the world and are highly elastic in nature.

Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firm etc.

Corporate Tax

It is levied on the company's profit income. There is no any separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown in separate head.

Wealth tax

It is imposed on the accumulated wealth or property of every individual, Hindu undivided family. Wealth tax is chargeable in respect of the net wealth exceeding ₹30 lakh at 1%. It does not yield enough revenue to the government.

Securities Transaction Tax (STT)

It was introduced in 2004 – 05. It is a tax imposed on transactions of Securities in Stock Exchanges.

Commodities Transaction Tax

It is a tax on the sale of commodities in Commodity Exchanges. It was introduced in 2013-14.

Minimum Alternate Tax (MAT)

It is a tax imposed on companies, which escaped corporate tax net or pay very low tax by using the provisions of exemptions, deductions, incentives etc, which are called Zero tax companies. It was introduced in 1996 – 97. In case, total income of the company after availing all eligible deductions is less than 30% of the book profits, the company shall be charged to a minimum tax as a percentage of total income. This is to ensure that companies pay at least a minimum amount of tax.

The same kind of tax imposed on commercial establishment other than companies like partnership firm, limited liability partnership firm etc., is called **Alternate Minimum Tax**.

2. Indirect Tax

If impact is on one point and incidence on some other point, it is called indirect tax. E.g. excise duty – levied on producer, but ultimately paid by consumer along with price.

Irrespective of spending capacity and purchasing power of people usually all

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were charged equal % of tax. It is well known that ₹10 is a big amount for a person who earns ₹100 per day but it is not the case for a person who earns ₹1000 per day. In this case, if both were required to pay equal amount of tax of ₹10, it puts higher burden on the first person than second. So these taxes are considered as regressive in nature.

But by imposing higher rate of taxes on luxury goods and lower rate of taxes on essential goods the progressiveness of indirect taxes is ensured to some extent.

Excise Duties

It is the tax on production of commodities

Customs Duties

It is the tax on import and export of commodities.

ModVAT (Modified VAT)

L.K. Jha Committee recommended it in 1976. It is an excise duty. Introduced as MANVAT (Manufacturing VAT). Then it was changed as ModVAT in 1986-87). Here, the taxes levied on final goods, tax on inputs and intermediate goods were abolished. Different tax rates were levied on different goods. Then it was modified as CENVAT (Central VAT) in 2000 – 2001 with uniform rate on all goods covered under this tax scheme.

Sales Tax /VAT (Value Added Tax)

It is a tax on sale of commodities. It is a state level sales tax. The tax rate is imposed as a% of value added. Hence, it is called VAT. Here consider a cotton shirt production. First the cotton sold is taxed. It is bought by a spinning mill owner. He has to pay for cotton including sales tax on it. He processes it into yarn and sells it to a weaver. Again sales tax is imposed. Here, the price includes cost of the cotton + sales tax on cotton + value added by spinner. So the tax amount already paid also gets taxed. It continues till the end product. It inflates the price of the end product. This is called the cascading effect. To avoid this and to bring about uniformity in sales tax throughout the country, it has been converted into VAT (Value Added Tax).

VAT was introduced with effect from April 2005. It is a multi-level tax. Here the different processors were repaid for the tax paid by them on their respective inputs. It is called **input tax credit or tax credit**. In the above example the spinner is repaid the sales tax paid by him on cotton. So producer pay tax only on the value added by him. Tax on tax is avoided. Cascading effect is undermined. So price rise is avoided.

Special features of VAT

Totally 550 goods come under VAT.

Two basic rates 4% and 12.5%

1 % for gold and silver ornaments

Exemption to 46 items comprising of natural unprocessed products in unorganized sector

Small traders with turnover up to ₹ 10 lakh

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exempted from the provision of VAT

Central Sales Tax

It is a tax on Sale of commodities in the interstate trade. It is imposed by the Union government but collected and retained by the state where the interstate trade commences.

It was 4%. It has to be phased out from April 1, 2007 by 1% every year and to be brought to zero by 2010. But it is still at 2 %.

Under the regime of GST Integrated GST (IGST) is proposed in place of CST.

Service Tax

It is a tax on the services provided. It was introduced in 1994-95. It is like sales tax. While sales tax is imposed on goods, it is imposed on services. Usually it is imposed on the service provider. For some service it is on the person who avail service. It is called "reverse charge". For some services it is imposed partially on service provider and partially on the person receiving the service. It is called "partial reverse charge or joint charge"

From 1st july of 2012 all the services are taxable barring the services listed in Negative List. Negative list is list of services which do not attract service tax.

GST (Goods and Service Tax)

It is a uniform tax on goods and services throughout the country. It is supposed to be implemented from 2010. It will have all features of VAT. In VAT, only goods are taxed but in GST both goods and services will be taxed on the basis of value addition method. If it comes, the taxes like excise duty and octroi will go away. There will be two GSTs namely State GST and Central GST.

If it is implemented the tax rate throughout India will be more or less same. So, it will give a feeling of India as single market. There will be no competition between states to reduce tax and attract investment. As multiple taxes go away, the cost to tax payer will come down. The price of goods and services will come down.

Octroi

It is a tax on the entry of goods into a local area for consumption, use, or sale. This is a check post based levy collected at entry points into urban local bodies.

FRBM ACT 2003

[Fiscal Responsibility and Budget Management Act]

FRBM Act was enacted in the year 2003 with the purpose of correcting the fiscal imbalances like high revenue and fiscal deficit. Apart from provisions of the act, FRBM rules also framed which fix targets of deficits among other things. Special features of the act and rules are as under.

Act

• Central Government to take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue

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deficit by March 31, 2008 and thereafter build up adequate revenue surplus

- Rule to be made under this Act to specify the annual targets for reduction of fiscal deficit and revenue deficit, contingent liabilities and total liabilities

- The revenue deficit and fiscal deficit may exceed targets specified in the rules only on grounds of national security or national calamity or such other exceptional grounds as the central Government may specify

- The Central Government shall not borrow from the RBI except by way of advances to meet temporary excess of cash disbursements over cash receipts

- RBI not to subscribe to the primary issues of the Central Government securities from the year 2006 – 07

- Central Government has to take suitable measures to ensure greater transparency in its fiscal operations. As a part of it, Central Government has to lay in each financial year, before both houses of parliament, three statements with Budget. They are:

1. Macroeconomic Frame Work

It contains assessment regarding the GDP growth rate, fiscal balance of the Central Government and the external sector balance of the economy.

2. Fiscal Policy Strategy Statement

The Statement explains how the current policies are in conformity with sound fiscal management principles and gives the rationale for any major deviation in key fiscal measures.

3. Mid-Term Fiscal Policy Statement

The Mid-term Fiscal Policy Statement, sets out three-year rolling targets for four specific fiscal indicators in relation to GDP at market prices namely

(i) Revenue Deficit

(ii) Fiscal Deficit

(iii) Tax to GDP ratio and

(iv) Total out-standing Debt at the end of the year

The Statement includes the underlying assumptions, an assessment of sustainability relating to balance between revenue receipts and revenue expenditure and the use of capital receipts including market borrowings for generation of productive assets.

Rules

- Finance Minister to make a quarterly review of trends in receipts and expenditure in relation to the budget and place the review before both houses of parliament

- Reduction of revenue deficit by an amount equivalent of 0.5 per cent or more of the GDP at the end of each financial year, beginning with 2004 – 05 and to be brought to zero by 2008-09

- Reduction of fiscal deficit by an amount equivalent of 0.3% or more of the GDP at the end of each financial year, beginning with 2004 – 05, so that deficit is less than 3% by 2008 – 09.[5]

- No assumption of additional liabilities (including debt at current exchange rate) in excess of 9% of GDP for the financial year 2004 - 05 and progressive reduction of this limit by at least one percentage point of GDP in each subsequent year to 6% by 2007 – 08.

- No guarantees in excess of 0.5 per cent of GDP in any financial year, beginning with 2004 – 05.

- Four fiscal indicators namely (i) Revenue deficit as a percentage of GDP, (ii) Fiscal deficit as a percentage of GDP, (iii) Tax revenue as percentage of GDP and (iv) Total outstanding liabilities as percentage of GDP are to be projected in the medium term fiscal policy statement.

- For greater transparency in the budgetary process, rules mandate the Central Government to disclose changes, if any, in accounting standards, policies and practices that have a bearing on the fiscal indicators.

- The Government is also mandated to submit statements of receivables and guarantees and a statement of assets, at the time of presenting the annual financial statement, latest by Budget 2006 – 07.

- The rules prescribe the form for the quarterly review of the trends of receipts and expenditures. The rules mandate the Central Government to take appropriate corrective action in case of revenue and fiscal deficits exceeding 45 per cent of the budget estimates, or total non- debt receipts falling short of 40 per cent of the budget estimates, at the end of first half of the financial year.

TAX REGIMES OF CENTRE & STATE

The Indian Constitution makes clear division of fiscal powers between the Centre and State governments in the 7th schedule.

The list I of 7th Schedule – Centre

1. Tax on income, other than agriculture income
2. Corporate tax
3. Customs duties
4. Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations
5. Estate & Succession duties other than agricultural land
6. Taxes on Capital value of assets except agricultural land (Capital Gain Tax)
7. Rates of Stamp duties on financial documents
8. Taxes other than Stamp duties on transactions in stock exchanges and future markets

5 The Government unveiled a revised fiscal consolidation map in October 2012. It targeted a fiscal deficit of 4.8 % for 2013-14 and through correction of 0.6 percentage point each year thereafter, a fiscal deficit of 3.0 percent of GDP by 2016-17.

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9. Taxes on Sales & Purchases of newspapers and on advertisements therein
10. Tax on railway freight and fares
11. Terminal taxes on goods or passengers carried by railways, sea or air
12. Taxes on the sale or purchase of goods in the course of interstate trade

List II - State

1. Land Revenue
2. Taxes on Sale and purchase of goods except news papers
3. Taxes on agricultural income
4. On land and buildings
5. Succession and estate duties on agricultural land
6. Excise duty on alcoholic liquors and narcotics but not including medicinal and toilet preparations
7. On the entry of goods into a local area
8. On the consumption and sale of electricity
9. On mineral rights (Subject to any limitations imposed by the parliament)
10. On vehicles, animals and boats
11. Stamp duties except those on financial documents
12. On goods and passengers carried by roads or inland water ways
13. On luxuries including entertainments betting and gambling
14. Tolls
15. On professions, trades, callings and employments
16. Capitation taxation
17. On advertisement other than those contained in newspapers
18. In the above division, more revenue yielding taxes are in the domain of the Centre. But the same constitution allocates more social and economic responsibility to states. To meet these responsibility states need more revenue. So the same constitution makes provisions to share the taxes of Centre between Centre and States.

Tax Sharing Mechanism

The Finance commission and Parliament are the two institutions for the tax sharing between Centre and states, and distribution of states' shares among different states. Now 80th and 88th amendments of the constitution govern this mechanism.

Before 80th amendment, only few taxes were sharable between Centre and States. The taxes like the corporate income tax were not sharable. The states demanded share in these taxes also. After taking into account this demand, the 10th finance commission recommended amendments in the constitution. The recommendation was accepted and the 80th amendment was made. As per 80th amendment, for the first time, 11th finance commission recommended sharing of all taxes.

After 80th Amendment, 2000

Art 270

All taxes and duties referred in the Union list except

a. Taxes come under Art 268

b. Taxes come under Art 269

c. Surcharge and

d. Cess

became sharable between Centre and the States. The share is decided by Finance commission

Art 268

a. Stamp duties and

b. Excise duties on toilet and medicinal purpose

are the taxes coming under this Article.

These taxes are levied (imposed) by Union government but collected and appropriated by states.

Art 269

As per this article the power to impose and collect following taxes is with the centre and the revenue has to be shared among states.

a. Interstate sale & purchase and

b. Interstate consignment

Under Central Sales Tax Act 1956, this tax imposed by Central government but the tax is collected by states. For this each state framed rules. The tax is collected and appropriated by the state from where the trade originates. Interstate consignment means transportation of goods from manufacturer to franchise to be sold to ultimate consumers. The franchise sell commodity on commission basis. It means the sales do not take place between manufacturers and franchise. But as the goods are ultimately sold CST is imposed.

Art 252

This article has the provision for the enactment of law in state subjects by parliament on the request of legislatures of two or more states. Under this article, any tax coming under the states' domain can be handed over to Parliament regulation. It is called Rental arrangement. As of now, there is no any such arrangement.

After 88th Amendment, 2003

Art 268 (A)

Under this article, Service Tax was introduced. As per this article this tax can be levied by Union government only but can be collected and appropriated by centre and states as per the law made by the Parliament.

In this regard the Central government enacted Service Tax Act 1994. But this tax is imposed as well as collected by Central government only. But this tax is sharable between centre and states. The share from Service tax collection is

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determined separately apart from other taxes that are shared.

National Emergency & Tax Sharing

Above mentioned provisions are applicable only in the normal times. In case of national emergency, under Art 358 (b), Parliament can make law to impose tax and duties even though not in union list and under Art 354, President may change provisions of articles from 268 to 279 during emergency.

RELATED TERMS

Cess

It is a tax additionally levied as a percentage of existing tax amount for specific purpose. For example, educational cess of 3% is levied on all central taxes. Let us take service tax rate as 12%. Then 3% of 12% is equal to 0.36%. Therefore, total tax rate is 12.36%. The tax amount collected as cess should not be used for purposes other than the purposes for which it is meant for.

Surcharge

It is also like cess. A tax additionally levied as a percentage of existing tax amount, but without any specific purpose. It is levied if the size of the tax base exceeds a certain threshold limit. For example corporate income tax up to ₹ 1 Cr is 30% on domestic companies and surcharge is 10% if income exceeds ₹ 1 Cr.

Note : the tax rate given here is an example. It keeps changing.

Countervailing duty

To encourage export, countries give subsidy to exporters. So, the cost of production for exporters comes down. Hence, exporters are able to export to other countries at a cheaper rate. It largely affects producers of the importing country. To counterbalance (countervail) this, importing countries impose duty on imported goods to raise the price of subsidized product to offset its lower price. This is called countervailing duty.

Anti-Dumping Duty

Dumping means exporting goods to other country in large quantity at a cheaper rate. There are two types of dumping.

1. Price dumping

It means selling goods in foreign country at price lower than the price of home country.

2. Cost dumping

It means selling goods in foreign countries at a price lower than cost of production. It is mainly aimed at wiping out the domestic producers from the market. It is also called **Predatory Dumping**.

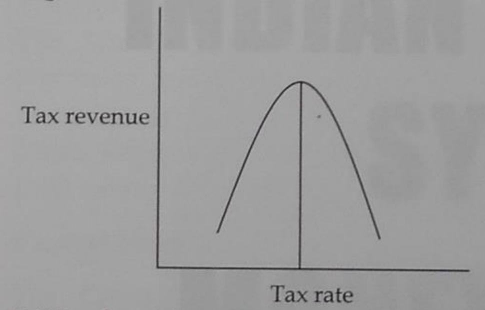
Duty Imposed on dumped goods is called Anti-Dumping Duty. Please remember that countervailing duty is to counter low cost and low price because of subsidy but anti-dumping duty is to counter voluntary low price to capture market.

Laffer curve

Laffer curve explains the relationship

between tax rate and tax revenue. It says that at lower as well as higher rate of tax, the tax revenue is low but tax revenue is high at optimal rate of tax. At lower rate, the tax collection is low. At higher rate of tax, there is high tax evasion and so there also the tax revenue is low. But, at optimal rate, there is no tax evasion and so the tax revenue reaches its maximum. The following figure 5.5 explains this.

Fig 5.5



Off-budget Liabilities

These liabilities arise not because of borrowing or use of the public money by government. These are money liable to be paid by the governments to various entities as a policy matter. For example, government has stake in keeping prices (inflation) at control. So, it does not allow the oil marketing enterprises (OMEs) to raise prices when the price of crude oil rises in the international market. In this regard, oil marketing companies incur some losses. To bear these losses in part, the Government issues bonds to OMEs. These bonds are interest bearing and have to be paid as money at the time of maturity. When these liabilities are not considered in calculation of deficits in the budget, though are equivalent to borrowed expenditure, come to be called as Off-budget liabilities.

Fiscal Slippage

If the actual fiscal deficit is more than what was expected it is called as fiscal slippage. For example in the budget, estimated fiscal deficit was 4.5% but the actual deficit at the end of the financial year is 7%, then it is called fiscal slippage.

Fiscal consolidation

Fiscal consolidation refers to long term permanent strategies to eliminate deficit by increasing the revenue and reducing the expenditure. The strategies dominated by revenue increasing method are preferred.

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CHAPTER 6

INDIAN FINANCIAL SYSTEM MONEY MARKET

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CHAPTER 6

INDIAN FINANCIAL SYSTEM MONEY MARKET

In this Chapter, I will learn

- RESERVE BANK OF INDIA (RBI) AND ITS FUNCTIONS
- COMPOSITION OF MONEY MARKET
- BANKING SCHEMES

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The financial system of India refers to the institutions of borrowing and lending of funds or demand for and the supply of funds of all individuals, institutions, and companies and of the government.[1] The Indian financial system can be classified into two broad categories.

1. Money Market
2. Capital Market

Money Market

The Money Market is the market for borrowing and lending of short – term funds say up to 3 yrs. The commercial banks, Regional Rural banks, Bill markets form money market.

Capital Market

The Capital Market is the market for borrowing and lending of medium and long term funds say above 3 yrs. Stock exchanges, development financial institutions form capital market.

This chapter covers Reserve Bank of India and its functions, composition of money market, banking schemes and sub markets.

RESERVE BANK OF INDIA (RBI) AND ITS FUNCTIONS

It is the apex regulatory body of Indian banking system. It keeps the cash reserves of all scheduled banks and hence is known as the "Reserve Bank". It is also called the central bank. It was established in 1935 under RBI Act 1934. It was owned by Private with Government share. It was nationalised in 1949.

General Superintendence and direction are carried by Central Board of directors. Apart from central board, RBI has four local Boards (Chennai, Mumbai, Calcutta, and New Delhi).

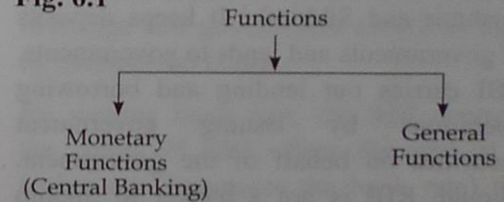
Functions of RBI

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."[2]

The functions of RBI can be classified as in Figure 6.1.

Fig. 6.1



Monetary Functions

Monetary functions are those concerned duly with money like issue of money, quantity of money, control of money supply etc. The following are the monetary functions.

1 http://www.rbi.org.in

2 http://www.rbi.org.in/scriptsAboutusDisplay.aspx#EP1

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1. Bank of Issue

Issue of new money is the exclusive right of RBI. All notes except ₹ 1 note and coins are issued by RBI. One rupee note and coins are issued by Ministry of Finance but circulated by RBI. It also exchanges or destroys old damaged currencies.

To issue money, RBI keeps ₹ 115 Cr in gold and ₹ 85 Cr in foreign securities as a backup. This is called Minimum Reserve System. This system is followed from 1957. The amount of new money is based on the prevailing economic condition, the need of the economy etc. RBI ensures that issue of new money does not lead to inflation.

2. Banker and debt manager to government

RBI acts as a banker to governments both centre and state (except Jammu and Kashmir and Sikkim).[3] It keeps deposits of governments and lends to governments. RBI carries out lending and borrowing operations by issuing government securities on behalf of the government. Though RBI is not a banker to Sikkim and Jammu and Kashmir it manages their public debt to some extent.

3. Banker's Bank

RBI is the banker of all banks. It keeps the reserves of banks like Cash Reserve Ratio (CRR) with it. It provides financial assistance to banks against mortgaged securities. It rediscounts bills of exchange.

Usually, banks and other financial institutions borrow and lend among themselves when there is enough liquidity (money supply) in the market. RBI facilitates and regulates it. Suppose, if there is liquidity crunch, the only avenue is RBI to borrow money. RBI provides enough money to banks. So it is called Lender of the Last resort. This happens very rarely in the economy of any country.

4. Custodian and manager of Foreign exchange

RBI is responsible for keeping the foreign exchange (foreign currency) that flows into the country and keeps the foreign exchange rate stable to certain extent.

5. Controller of Credit

RBI acts as controller of credit. Control of credit means control of lending and deposit creating capacity of the banks. These controls results in control of money supply. Control of money supply is essential to control inflation and thereby promote economic growth because both partly depend on money supply.

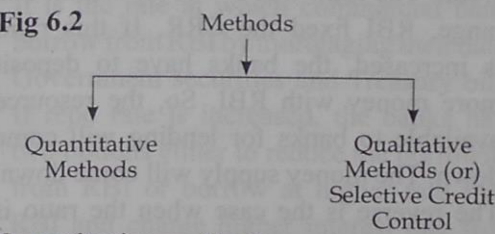
Methods of credit control

The methods of credit control are of two types. One is Quantitative methods and another one is Qualitative Methods as shown in figure 6.2. Both methods use conventional and non-conventional measures or tools.

The conventional tools or measures are those which are being used for a long time. Non-conventional measures are those which have been introduced recently, say after the 1990s reform.

3 Reserve Bank of India: Functions and Working, p.34

Fig 6.2



Quantitative methods

Quantitative methods aim at controlling the cost and quantity of credit. It does not discriminate between different sectors and end use of credit. These measures are applicable for the whole of the economy.

Conventional measures

The conventional tools used are Bank Rate, Open Market Operation, and Variable Reserve Ratio.

1. Bank rate Policy (or) Discount Rate Policy

Before learning what is bank rate and its operation, it is better to know what is bill of exchange and discount.

Bill of exchange means a written document that assures payment of money by purchaser to seller for the goods purchased, at a future date.

Discount means the process of converting a bill into money at an earlier date than that is mentioned in bill of exchange(maturity date). The discount is carried if the receiver of bill of exchange needs money urgently. In this process, the receiver can approach a bank. The bank accepts the bill of exchange and pays. For that, it deducts some percentage of money as interest. For example, for a bill of exchange of ₹ 1000 the bank may pay ₹ 920 after deducting 8% interest.

The bank will receive full amount from purchaser , on the maturity date. Otherwise, the bank will convert these into money at a lesser discount rate from RBI. For example, at 6% and will receive ₹ 940. The profit for bank is ₹ 20. This is called rediscount. This rate is called bank rate or discount rate. Apart from bills of exchange, the commercial banks get their government securities discounted from RBI.

To be precise, the bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks.

By varying bank rate, the RBI controls the credit. If RBI offers discount at a higher rate (increases the bank rate) the bank's profit may be affected. So, it will not approach RBI for discounting or will charge higher discount rate from customer. So the customer may not discount his bill. Hence, the money supply will be low. The reverse is the case when RBI reduces the bank rate. So, depending on the economic condition, RBI alters the bank rate. If there is high inflation, the bank rate will be high and vice versa.

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2. Open Market Operations

This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial institutions by the Central bank. The financial instruments like securities, bills and bonds are written documents that are issued to banks and public against money given by them. If the central bank sells these instruments, banks and public will buy it and pay money to the Central bank. If the Central bank buys these instruments from instrument holders, it will pay money to the latter.

Through buying of financial instruments, the money supply is increased. The banks will have more money with them. The public who sold will deposit the money with the banks. So the resource of banks increases that helps to increase their lending capacity. When there is more money supply, the interest will come down. Therefore, more people will borrow from banks. The reverse is the case when Central bank sells financial instruments.

3. Variable Reserve Ratio

In these methods, the reserves that scheduled banks have to maintain are varied to control the credit creation. There are two types of reserves.

i. Cash Reserve Ratio (CRR)

Scheduled banks are required to keep certain percentage of their Net Time and Demand Deposits with RBI under RBI Act 1934. It can be shown in a formula.

Cash reserve ratio = Cash reserve/Net time and demand deposits X 100

This is aimed to have control over banks credit. The ratio was 3 – 15%. Within this range, RBI fixed the CRR. If this ratio is increased, the banks have to deposit more money with RBI. So, the resource available to banks for lending will come down. The money supply will come down. The reverse is the case when the ratio is decreased. As per RBI (Amendment) Bill 2006 enacted in June 2006, the Floor and Ceiling condition of 3-15% was removed.

ii. Statutory Liquidity Ratio (SLR)

Scheduled banks are required to keep certain percentage of their net time and demand deposits in their vault itself. It need not be deposited with RBI. This reserve is a precautionary measure. It prevents bank from lending all its deposits which is too risky and it is mandatory under Banking Regulation Act 1949. The ratio is 25 – 40% of Net Time and Demand Deposits. This reserve has to be kept in the form of cash, gold, and bond. As in the case of CRR, this reserve is varied to control the credit.

Non-Conventional Measures

The non-conventional measures are liquidity adjustment facility (LAF), marginal standing facility (MSF) and market stabilisation scheme (MSS).

1. Liquidity Adjustment Facility (LAF)

It is a short term credit control measure. It is to absorb the excess Liquidity (money

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supply). It has two instruments, namely Repo rate and Reverse Repo rate.

i. Repo Rate

It is the rate at which commercial banks borrow from RBI by mortgaging their dated Government securities and Treasury bills. If repo rate is increased, the banks have two options either to reduce the borrowing from RBI or borrow at higher rate from RBI and charge higher interest rate from customer. If banks borrow fewer amounts, the credit creating capacity of banks will come down and money supply will come down. If bank borrows and charges higher interest rate, the customer will borrow less. The money supply will come down. If the repo rate is decreased the reverse will be the case.

Take an example; the repo rate is 6.5 % and the banks borrow from RBI at this rate of 6.5 % and raise deposits at 4.0% of interest from customers. Deposit is also a source of fund for banks to lend. Assume that the average of repo rate and deposit rate result in 6% of cost to banks. This is called cost of fund. And the bank lends to its customer at 10%. In this the banks earn 4.0% profit. Now, the RBI raises repo rate from 6.5% to 7.5%. The banks will reduce or stop its borrowing from RBI because if it borrows at 7.5% and lend at 10% its profit will come down. Otherwise, it will borrow at 7.5% from RBI and may lend at 11% to its customer to keep its profit at 4.0% level. It means the interest rate is increased. Now the customer will not borrow at this higher rate or will reduce his borrowings. Hence, the money supply will come down.

ii. Reverse Repo Rate

It is the rate at which RBI borrows from commercial Banks by mortgaging its dated Government securities and Treasury bills. If the reverse repo rate is increased, the banks have two options either to lend to RBI or lend to customer at higher interest rate. If banks lend to RBI, the money available with the bank to lend to its customer will come down. The credit creating capacity of banks and money supply will come down. If the banks raise interest rate on loans to customers at higher rate, the customer will borrow lesser amount. So, the money supply will come down.

Take an example; the reverse repo rate is 8.0 %. The banks lend at 10% to its customer when its cost of fund is 7% and earns 3% profit. Now, RBI raises the reverse repo rate from 8% to 9%. The bank will shift its lending from customer to RBI because it can earn higher interest rate of 2 %. Though the profit in lending to RBI is less than lending to customers, the banks will prefer RBI. This is because banks have an advantage in lending to RBI, as it is an reliable customer and loan is of short term nature and can lend in bulk. It can earn profit quickly. In this situation, if customers want to get loan from banks, it will charge higher interest from customer because it involves risk and cost. So, it will lend to customer only if it can get higher return than the return it gets from RBI. So,

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the interest rate to customer may increase from 10 to 11%. It means, the interest rate is increased. Now the customer will not borrow at this higher rate or will reduce his borrowings. So, the money supply will come down.

2. Marginal standing facility

It is a loan facility given by RBI to banks which have current and SGL (Subsidiary General Ledger) account with RBI. It is a loan for overnight (one day). This facility is available from May 9, 2011. It is more similar to Liquidity Adjustment Facility (Repo and Reverse Repo), but there are many differences.

The loan is given against the mortgage of eligible securities. The eligible securities are Government dated securities, Treasury bills and State Development Loans. The maximum amount of loan is 1% of Net Demand and Time Liabilities (NDTL). The loan size will be minimum one Crore and further amount is in multiples of one Crore. The interest rate for MSF is Repo rate plus 1%.Usually, the Reverse Repo rate is Repo rate minus 1%. Therefore, the Repo rate act as an anchor rate. The Repo rate stands in the middle. The MSF rate stands above and Reverse Repo rate stands below the Repo Rate

3. Market Stabilisation Scheme

It is not a pure monetary instrument. It is a fiscal cum monetary instrument. It is a facility to control liquidity due to excess foreign exchange flow into the country. In this facility, the RBI issues government securities to absorb excess liquidity. The interest is paid by Ministry of Finance, Government of India. The amount of issue and date of issue is decided by RBI in consultation with Ministry of Finance, Government of India.

Qualitative (or) Selective Credit Controls

These methods control the use and direction of credit. These methods discriminate between sectors. They control the credit flow to particular sector or to particular end use.

As of now RBI is not using this method for control of credit. It mostly uses quantitative control method.

1. Regulation of Margin Requirements

Margin is the amount that has to be contributed by borrower towards the purpose for which she/he borrows. For example, if someone wants to buy a machine she/he cannot get full amount as loan. She/he has to contribute a certain amount to purchase the machine.

By varying this amount, the off take of loan can be controlled. If the margin is high the off take of loan will be low and vice versa. Different margin is fixed for different sector. If RBI wants to control flow of credit to particular sector, it will fix high margin and vice versa. This is primarily aimed to prevent excessive use of credit to purchase or carry securities by Speculators.

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2. Regulation of Consumer Credit

Consumer credit refers to credit to consumer to purchase durable consumer goods on installments and hire purchase. Two devices are available under this method. They are

i) Minimum down payment

ii) Period of repayment

Minimum down payment means the amount initially to be paid by the purchaser. If this amount is fixed high, the purchase will come down and vice versa. So is the demand for credit. If the number of installment is reduced, the consumer has to pay more money per installment. This will discourage credit off take and vice versa. Therefore, higher minimum down payment and less number of installments reduce money supply and vice versa.

3. Rationing of Credit

In this method, the maximum amount of credit flow to a particular sector is controlled. There are two methods of rationing of credit. They are,

a. Variable Portfolio Ceiling

b. Variable Capital – Risk Weighted Asset Ratio

a. Variable Portfolio Ceiling

The maximum amount of credit for various portfolios (various sector) is fixed. Different ceiling for different sector is fixed.

b. Variable Capital – Risk Weighted Asset Ratio

Capital to Risk Weighted Asset Ratio (CRAR) is also called **Capital Adequacy Ratio (CAR)**. It means the availability of sufficient capital as a percentage of risk weighted assets. It is expressed in formulaic form as follows:

CRAR = Capital / Risk Weighted assets X 100.

The Balance sheet of banks that shows the financial position of banks consists of two sides. One side shows the liabilities and the other shows assets. Liabilities mean the amount of money the bank has to pay to others. So the shareholders money, that is capital, which the bank is liable to pay if claimed by shareholders, is shown on the liabilities side. The assets mean the amount of money that has to be paid by others to bank. So, the loans lent by banks are listed on the asset side.

The RBI in its monetary policy assigns some risk to loans. This is based on the likely chance of a loan be repaid or not repaid. For example, a bank can expect surely that a loan paid to rice vendor will be repaid but cannot expect a loan paid to stock broker because stock exchange trading is a risky one. It means, lending to stock broker is highly risky. So, the loan to rice vendor may be assigned a risk of 100% and the loan to stock broker may be assigned a weight of 150%. So, a loan of ₹ 1000 to rice vendor will be considered as ₹ 1000 (100/100*1000=1000) but loan to

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stock broker will be considered as ₹ 1500 (150/100*1000=1500). This is called risk weighted asset.

The capital is more or less fixed. If the capital to risk weight ratio is changed by RBI, only the asset has to be adjusted. That is the amount of loan has to be changed. So, credit can be controlled.

If the risk assigned to a particular sector is high, it will reach the ceiling with low amount of credit and vice versa. So, by varying the ceiling and **Capital to Risk Weighted Asset Ratio (CRAR)** the flow of credit can be controlled.

RBI uses this Capital to Risk Weighted Asset Ratio as norm to ensure that banks do not lend beyond its capacity. This ratio is fixed under the Basel norm. It is elaborated later.

4. Direct Action

In this case, the Central bank issues certain policy decisions from time to time based on prevailing situation in the economy. For example, the central bank may require scheduled banks to send proposals for loans beyond a certain amount to be scrutinised by the central bank. This has to be followed by the scheduled banks.

5. Moral Suasion

Moral suasion means methods of persuasion, method of request, method of informal suggestion and method of advice to commercial banks, about dos and don'ts by calling a meeting. The banks are morally bound to follow this but it is not mandatory.

6. Publicity

Publicity means the publication of weekly or monthly statements of assets and liabilities of commercial banks through periodicals and websites. This brings greater transparency. It puts moral pressure on erring banks not to violate norms. So, banks abide by credit control measures.

Non-Monetary Functions

Non-monetary functions are aimed at general regulation of banking system to ensure a vibrant and prudent banking system. These functions are classified as Supervisory Functions and Promotional Functions.

Supervisory Functions

Under supervisory function, RBI issues license to banks. It issues policies and guidelines for management and method of working, amalgamation, reconstruction and liquidation of the banks. It calls for returns and information from the banks. It carries out periodical inspection of players in the money market.

As a part of supervisory function, RBI ensures transparency in the working of banking system. The recent initiative in this regard is **Base rate**. This was introduced from 1st July, 2010. Base rate is the minimum rate below which banks cannot lend. For example, if IOB announces its base rate as 8%, it cannot lend below 8% to any of its customers. But each bank has right to fix its own Base rate. The condition

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is that the banks have to provide verifiable method of calculation used to arrive at the rate announced. The exception to this are the loans to Diffrential Interest Rate (DIR) scheme, loans to banks' own employees and loans to banks' depositors against their own deposits can be lent below the Base rate.

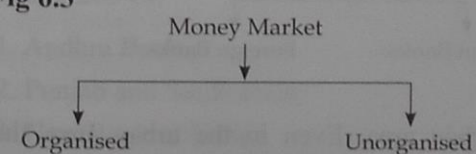
Promotional functions

RBI works towards promotion of Indian financial system. It takes care of branch expansion and promotes banking habit of people. It establishes and promotes new specialized agencies.

COMPOSITION OF MONEY MARKET

Money market of India has participants both from organised and unorganised sector as shown in figure 6.3. The organised sector is characterised by registration, approval and license from market regulators and proper maintenance of accounts. The unorganised sector is devoid of these aspects.

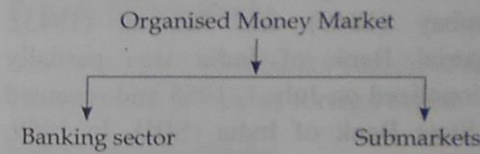
Fig 6.3



Organised sector

Organised sector consists of banking and sub markets as shown in figure 6.4. Banking sector carries out both, deposit taking and lending operations. The sub markets do the money transaction among banks and generate necessary capital for banking sector and commercial sector.

Fig 6.4



Banking Sector

Banking Sector consists of commercial banks, Regional Rural Banks and Cooperative banks. It is shown in figure 6.5 in the next page.

Commercial Banks

Commercial banks are run on commercial basis. They accept deposits, give loans and provide other financial services to earn profit. These are regulated under Banking regulation act 1949. Commercial banks consist of both public sector and private sector banks.

Public Sector Banks

Public sector banks are those banks in which the majority of ownership is with government. The majority of ownership means, shareholding of more than 51%.

All the public sector banks were not started by Government of India. Some banks which were in the hands of private were nationalised and made public sector banks.

State Bank Group

State Bank group means State Bank of

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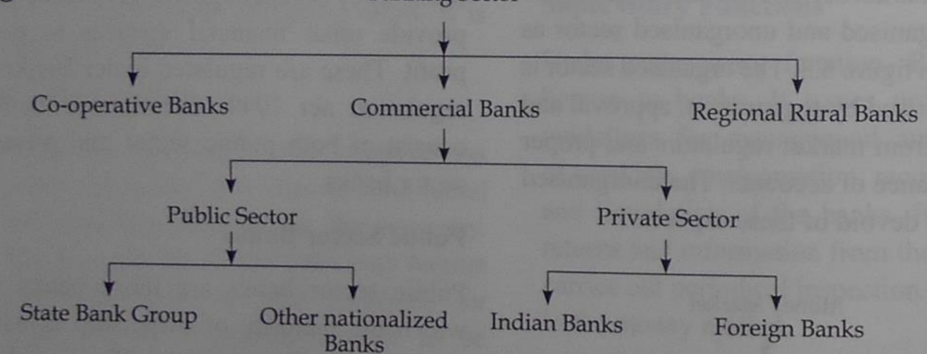
India (SBI) and its Associates. Previous name of SBI was Imperial Bank of India. It was created in 1921 by amalgamating the three Presidency Banks of Bengal (1806), Bombay (1840) and Madras (1843). Imperial Bank of India was partially nationalized on July 1, 1955 and renamed as State Bank of India (SBI). In 1959, eight banks of former princely states were brought under SBI as its associates.

They are:

1. State Bank of Bikaner
2. State Bank of Jaipur
3. State Bank of Hyderabad
4. State Bank of Indore
5. State Bank of Mysore
6. State Bank of Saurashtra
7. State Bank of Patiala and
8. State Bank of Travancore

Among these banks State Bank of Bikaner and State Bank of Jaipur were merged and called as state bank of Bikaner and Jaipur. State Bank of Saurashtra was merged with parent bank State Bank of India on October 2008. Now the associate banks are six. SBI is the largest public sector Bank in the country. Previously major part of SBI's share was held by RBI. To endow RBI with only the regulatory functions, and to unload its administrative work, RBI's shareholding transferred to Government of India.

Fig 6.5



Other Nationalised Banks

Before nationalization, the banks were mainly concentrated in the urban area, while the rural areas lacked the banking facility. Though there were some bank branches in rural areas, they were used only to mobilize the deposits of rural area and that money was used to lend in the urban area. Even in the urban area, the banking facilities were enjoyed by rich people. The poor people were left out of the banking net. The banks were mainly owned by Industrialists. They used these banks to mobilize deposits of people and themselves got loan from these banks. To make the banking facilities available to all,

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private banks were nationalised.

The nationalisation was carried out in two stages. On 19th July1969 fourteen large Commercial Banks which had reserves more than ₹ 50 Crores were first nationalized. They are:

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Canara Bank
5. United Commercial Bank
6. Syndicate Bank
7. Bank of Baroda
8. United Bank of India
9. Union Bank of India
10. Dena Bank
11. Allahabad Bank
12. Indian Bank
13. Indian Overseas Bank
14. Bank of Maharashtra

Secondly, 6 banks were nationalized on April 15, 1980 which had reserves more than ₹ 200 Cr.

1. Andhra Bank
2. Punjab and Sindh Bank
3. New Bank of India
4. Vijaya Bank
5. Corporation Bank
6. Oriental Bank of Commerce

In September 1993, New Bank of India was merged with Punjab National Bank. Then the total nationalized Banks came to nineteen. Therefore, total number of public sector commercial banks are (1+6 + 19) twenty six.

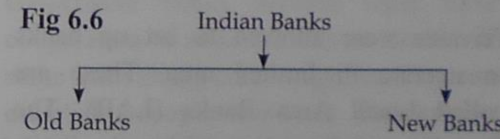
Private Sector Banks

Indian private sector banks consist of both Indian banks as well as foreign banks.

Indian Private Banks

Indian banks are classified as old and new private sector banks as shown in figure 6.6. This classification is done by RBI for the convenience of comparing performance of all Indian banks.

Fig 6.6



Old Banks

The banks except those were nationalised, continued to be in the hands of privates. These private banks and those Banks which were set up before 1990s are called Old Banks.

New Banks

Banks set up in the private sector in 1990s and after are called new banks. Latest by 2014 RBI issued license for new banks.

It also came up with proposal for small banks and payment banks. The RBI observes "Both, payments banks and small banks are "niche" or "differentiated" banks; with the common objective of furthering financial inclusion. While small banks will

provide a whole suite of basic banking products, such as, deposits and supply of credit, but in a limited area of operation, payments banks will provide a limited range of products, such as, acceptance of demand deposits and remittances of funds, but will have a widespread network of access points particularly to remote areas, either through their own branch network or through Business Correspondents (BCs) or through networks provided by others. They will add value by adapting technological solutions to lower costs." [4]

Local Area Bank in Private Sector

Privates were allowed to set up banks to operate in limited area. These are called Local Area Banks (LAB). The branches can be set up within the limits of geographically 3 contiguous districts. Backward and less developed districts are considered for area of operation of LABs These were set up to meet the local credit needs by exploiting local resources itself.

They are registered under The Companies Act 1956.The required minimum paid up capital is ₹ 5 Crore. The promoter should contribute at least ₹ 2cr. These Local Area Banks are regulated under RBI Act 1934, Banking regulation Act 1949 and Regional rural Bank (RRB) Act 1976.

Foreign banks

After 1991 economic reforms, India opened the door for foreign banks. They set up either branches or subsidiaries. Citi bank, Barclays, and ABN Ambro are few foreign banks to be mentioned.

Indian Banks Abroad

Like foreign banks set up in India, Indian banks set up their branches or subsidiaries in foreign countries. Both Public and Private sector banks have branches abroad. Off shore banking units are located in Bahamas, Cayman Islands, Channel Islands and Mauritius. Off shore banks are banks located in a country that has more generous tax laws.

Amas Bank, Geneva, Switzerland is the first Private Bank established in Europe by Indian nationals (by Hinduja Group).

Classification of Banks

Banks are classified into scheduled and non-scheduled banks. All commercial banks, regional rural banks, and state co-operative banks are classified like this.

1. Scheduled Banks

Scheduled banks are those listed in the 2nd schedule of RBI Act 1934. A bank to be included in this list has to fulfill the following two conditions.

i. The paid up capital and collected funds of bank should not be less than ₹ 5 lakh.

ii. Any activity of the bank will not adversely affects the interest of depositors.

Any bank which fulfilled these conditions and got listed in the second schedule if violates these conditions will be de-

4 http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=31646

scheduled. Scheduled bank enjoys the following facilities:

They are eligible for obtaining debts / loans on bank rate from RBI.

They get automatic membership of clearing house.

They can avail the facility of rediscount of first class exchange bills from RBI.

2. Non Scheduled Banks

The banks which are not included in the second schedule are called non scheduled banks. Like scheduled banks, these banks also have to follow the conditions regarding Cash Reserve Ratio (CRR) but can keep it with itself. These banks are not eligible for loan from RBI, but become eligible under emergency conditions.

The Regional Rural Banks (RRB)

These banks were established since 1975, under RRBs Act 1976. RRBs were set up in all states except Sikkim and Goa. Totally 196 Banks were set up. These banks were set up by public sector banks. The public sector bank which set up a particular RRB is called sponsor bank of that RRB. For example Pandian Gram bank, a RRB, was set up by Indian Overseas Bank. Indian Overseas Bank is called sponsor bank of Pandian Gram bank.

The purpose is to further increase credit flow to rural areas. RRBs were established to lend to weaker section called target group like landless labour, artisan and craftsmen at concessional rate. From 1997, RRBs were freed to lend outside the target group.

Since April 1987, no new RRBs have been opened due to the Kelkar committee's recommendations. Many of the RRBs became unviable or less profitable. To solve the problem, weak banks are being merged with the efficient banks. The merging of RRBs is going on. Now, they gain more autonomous power also.

Co-Operative Banks

Cooperative banks are established by State laws. These banks are called as cooperative banks because these have cooperation of stake holders as motive. If some individuals come together, they can establish a cooperative bank. Cooperative banks are established with the aim of funding agriculture and allied sectors and to finance village and cottage industries. Along with lending, cooperative banks accept deposits. They operate on the principle "one person one vote" in decision making. NABARD (National Bank for Agriculture and Rural Development) is the apex body of cooperative sector in India.

NABARD

NABARD is also called as the National bank. Previously, the functions of NABARD viz., financing of agriculture and refinancing of cooperative banks and RRBs was done by Agriculture Refinance Development Corporation (ARDC) of RBI. NABARD was set up in July 1982. It took over the functions of Agriculture

Refinance Development Corporation (ARDC).

The Composition of Cooperative Banks

The cooperative banks are divided into urban and rural. Further, they are divided into short term and long term structure. It is shown in figure 6.7.

Short Term Structures

Short term structures lend up to one year. They lend for cultivation activities and provide working capital to buy seeds, fertilisers etc. The short term structure cooperative banks have a 3 tiered set up. They are:

a. State Co-operative Bank

b. Central or District Co-operative Bank

c. Primary Agricultural Credit Societies

State Co-operative Bank (SCB)

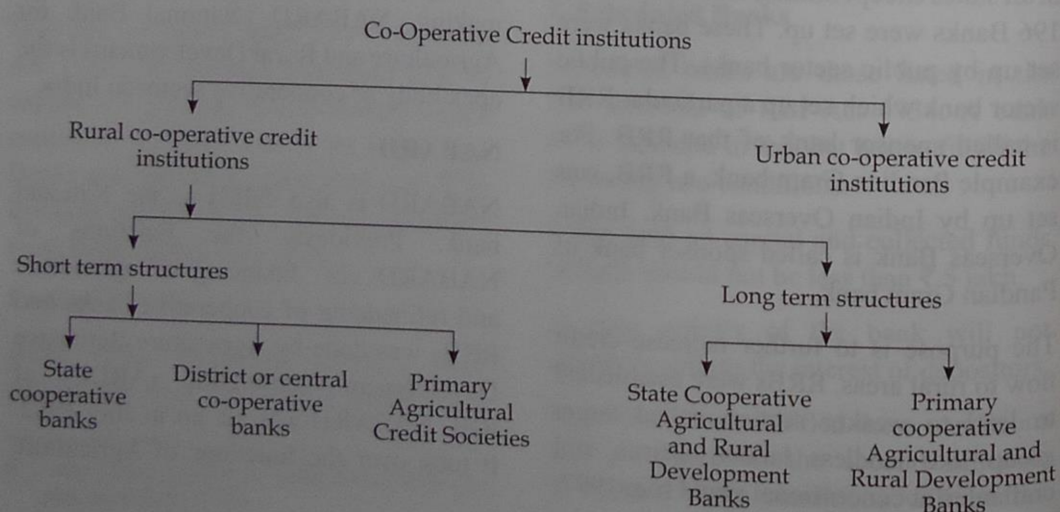
Each state has its own State Co-operative Bank. It is the Apex body for cooperative banks in a particular state. They act as a mediator or as an intermediary between RBI and NABARD on the one side and Central or District Co-operative Bank and Primary Agricultural Credit Societies on the other side. They get loan from RBI at concessional rate. It gives grants to co-operative banks in the state.

Now, the intermediation of these banks is abolished by a memorandum of under-standing between RBI and these banks. Now, RBI has direct dealing with low tier cooperative banks.

Central (or District) Co-operative Bank

This cooperative bank operates at district level. Its operational area is limited to one

Fig 6.7



district. There are two types of Central (or District) Co-op Banks.

They are:

a. Co-operative Banking Union

b. Mixed Central Co-operative Bank

The membership of Co-operative Banking Union is open only to co-operative societies. But, the membership of Mixed Central Co-operative Bank is open both to co-operative societies and individuals.

The Central (or District) Co-operative Banks get loan from SCBs (State Co-operative Bank). They grant loans to PACs (Primary Agricultural Credit Societies) and individuals.

Primary Agricultural Credit Societies

These cooperative banks operate at village level. They provide short term loan to agriculture (1 year sometimes 3 years). PACs give loans to its members that are individuals.

Long Term Structures

Long term structures lend to meet medium and long term fund requirements. It ranges from one and a half years to twenty five years. They lend for land development, construction of wells, purchase of pump sets, redemption of old debts etc. These banks initially were called as mortgage banks. Earlier they were called Land development banks. Now they are called Cooperative Agricultural and Rural Development Banks (CARDBs).

It is a two tiered structure. They are;

1. State Cooperative Agricultural and Rural Development Banks

2. Primary Cooperative Agricultural and Rural Development Banks

Urban Co-Operative Credit Institutions

The co-operative banks set up in the urban and semi urban areas are called Urban co-operative credit institutions. They mainly lend to small borrowers and businesses.

Sub Markets

Government, financial institutions and industries need resources for investment and to meet shortage if any in the money for regular activities. Sub markets are markets to generate resources needed to meet these needs.

Composition of Sub Markets

The sub market is divided into various segments. It is based on the financial instruments used in this market. It is diagrammatically shown in figure 6.8.

Call Money Market

It is also known as money at call and short notice market. It deals in loans for a period ranging from one to fourteen days. It is an inter- bank borrowing and lending market. One bank demands money from another bank to cover its cash reserve requirements with RBI every fortnight and to gain from foreign exchange market. The rate at which funds are borrowed in these markets is called call money rate.

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It has two segments. They are as follow:

The Call Market (or) Overnight Market

It is a market for borrowing and lending of money between banks within one day.

Short Notice Market

It is a market, for borrowing and lending of money between banks up to fourteen days.

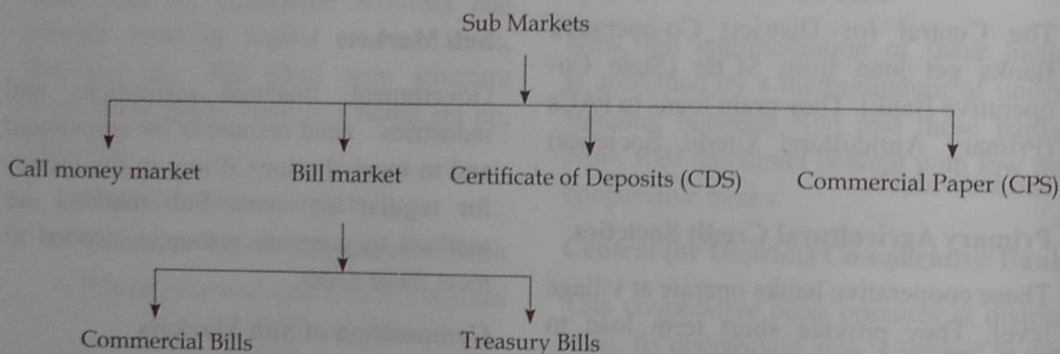
Bill Market (or) Discount Market

In bill market, short term funds (usually 90 days) are bought and sold. The bill market consists of two markets, one is commercial bill market and another is Treasury bill market as shown in figure 6.8

Commercial Bill Market

Commercial bills are bills other than

Fig 6.8



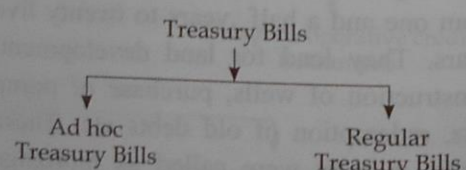
treasury bills. They are issued by industries and traders.

Treasury Bill

Treasury bills are securities issued by Government treasury. They are of short term in nature. In this regard, they differ from market loans. They are non-interest bearing (zero interest/ zero coupon). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. For example, a security worth of ₹ 1,000 may be issued against receipt of amount lower than ₹ 1000. The purchaser of security can redeem the full ₹ 1,000 at a particular date (maturity date). This is called redemption at **par** (original value).

There were two types of Treasury Bills. They are shown in the following figure 6.9

Fig 6.9



Ad hoc Treasury Bills

It was issued for a particular end or case in hand. Till 1991-92, there was only Treasury bill of 91 days. It was called as

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ad-hoc Treasury bill. It was discontinued from 1997-98. To replace it ways and means advance was introduced.

Regular Treasury Bills

These bills are issued regularly to meet budgetary expenditure. There are number of Treasury bills with differing maturity. In 1998-99, 182 days Treasury bills were introduced. But it was replaced by 364 days Treasury bills. Again 182 days treasury bills were reintroduced. 14 days Treasury bills were introduced in 1999-2000.

Dated Government Securities

The government securities with long term maturity are called Dated Government Securities. The government of India sells dated securities of 5 years maturity and 10 years maturity on an auction basis. There are dated Government securities with 30 years maturity period.

Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are issued by Commercial Banks and Financial Institutions to raise additional fund. These are issued in multiples of ₹ 25 lakh, subject to a minimum amount of ₹ 1 crore. The maturity period range from 3 months to one year in the case of banks and one year to 3 years in the case of other financial institutions.

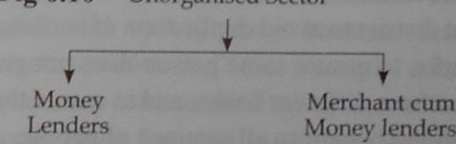
Commercial Papers (CPs)

IIt was introduced in 1990. Commercial Papers (CPs) are issued by Corporate, Primary Dealers (PDs) and the All-India Financial Institutions (FIs) to raise fund. These are issued in denominations of ₹ 5 lakh or multiples of it, subject to a minimum amount of ₹ 1Crore. The maturity period is 3 to 6 months.

Unorganised Sector

The unorganised sector banking is not a registered and regulated one. They do not maintain proper account. The unorganised sector has two types of participants. It is shown in the following figure 6.10.

Fig 6.10



The interest rate is usually high in unorganised sector. The lending and borrowing operation is less cumbersome because many of the procedures followed by banks are not followed in unorganised sector.

Money Lenders

The money lendersare exclusively engaged in money lending operations. It is their source of livelihood.

Merchant cum Money Lenders

The merchant cum money lenders are engaged in merchandising and money lending. They lend to producers of the product in which they merchandise. The producers have to sell their products only to the lender. In this case merchant cum money lenders usually purchase products at low price.

BANKING SCHEMES

Many schemes were launched in Banking Sector after nationalization of bank. These schemes were launched to enhance spread of banking services to all the regions of the country and to increase banking habit among people.

Lead Bank Scheme

In this scheme, any one public sector bank is selected in a district. That bank is designated as Lead bank of the district. It co-ordinates the activities of all banks in that district to avoid duplication of banking works, to ensure same person does not get loan from different banks, and to ensure the banking benefit to all sections of people.

Service Area Approach (1988)

It operated under Lead Bank Scheme. Each semi urban & rural branch allotted a specific area (cluster of village) to implement banking scheme.

Differential Rate of Interest Scheme (1972)

Public Sector banks were directed to grant at least 1% of their total deposits of previous year to weaker sections of society at a concessional rate of 4%. At least 40% loan under this scheme to SC/ST people is made compulsory.

Social Banking

Financing of poverty reduction and employment programme of government by banks is called social banking. Under this scheme, beneficiaries of government's self-employment programme and those who got training from government programme are provided with loan.

Priority Sector Lending

Priority sectors are those sectors which substantially contribute to National Income but get less credit from banking sector. The priority sector list is provided by the RBI. The list is being revised frequently. A target of 40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off- Balance Sheet Exposures (OBE), whichever is higher, had been stipulated for lending to the priority sector by domestic Scheduled Commercial Banks (SCBs) (both public and private sector). Within this, sub-targets of 18 per cent and 10 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to agriculture and the weaker sections respectively.[5]

The sub target of 18% for agriculture is further sub divided into 13.5% of direct lending and 4.5% of indirect lending. The loans provided to agriculture activities are considered as direct lending. The loans provided for personal consumption of rural mass and to agriculture allied activities like food processing are considered as indirect lending.

The priority sector lending target for RRBs is 60%. A target of 32 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated

5 Economic Survey 2008-09.p.97

for lending to the priority sector by foreign banks having offices in India. Within this, sub-targets of 10 per cent and 12 per cent of ANBC or credit equivalent amount of OBE, whichever is higher, had been stipulated for lending to micro and small enterprises and export sectors respectively.[6]

Shortfalls in the priority sector have to be deposited with NABARD's Rural Infrastructure Development Fund. NABARD lends this amount to state governments for rural development activities.

Adjusted Net Bank Credit (ANBC) means net bank credit plus non-SLR bonds held to maturity. Net bank credit means the difference between outstanding gross deployment of bank credit at the start of the financial year and end of the financial year.

ANBC = Credit outstanding at the end of financial year – Credit outstanding at the start of financial year

Non-SLR bond means the bonds which are not qualified to be invested for the purpose of Statutory Liquidity Ratio (SLR) stipulated by RBI. RBI classifies bonds which are eligible for SLR and other bonds are considered as non- SLR bonds. Investments in these bonds are considered equal to credit given to corporate sector by banks. Held to maturity means, the investment made with purpose to keep it invested till maturity date and not for trading purpose.

Off balance sheet exposure means assets and liabilities which are not qualified as assets and liabilities at present but likely to become so in future. RBI observes: "Off-Balance Sheet exposures refer to the business activities of a bank that generally do not involve booking assets (loans) and taking deposits. Off-balance sheet activities normally generate fees, but produce liabilities or assets that are deferred or contingent and thus, do not appear on the institution's balance sheet until and unless they become actual assets or liabilities." For example, a bank guarantee loan availed by someone from some other financial institution. Actually this is not the liability of the bank. But if the person who availed loan fails to repay, the bank becomes accountable and the loan become the liability of bank. These types of liabilities and assets are called off balance sheet exposure.

Financial Inclusion

Financial inclusion means including the people, hitherto excluded, into the financial system. The inclusion is to be done on both supplying end (saving account) and receiving end (loans from financial institutions). Towards this end the RBI started "No-frills account" drive. The banks were requested to open "No-frills account" with low or minimum balance.

No- frills means including only the basic features without anything unnecessary especially things added to make something

6 Economic Survey 2008-09.p.97

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more attractive or comfortable.[7] No-frills account means accounts without premium services that are charged some amount. This reduces the cost of holding account. It enables even poor people to hold bank account.

In place of No-frill account Basic Savings Bank Deposit Account (BSBDA) was introduced. This account shall not have the requirement of any minimum balance. No charge will be levied for non-operation/ activation of in-operative 'Basic Savings Bank Deposit Account'. These accounts are now opened under Prime Minister Jan Dhan Yojana with the aim of opening at least two accounts per family.

Promotion of Micro Credit

Micro Credit is defined as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards. Micro Credit Institutions are those which provide these facilities.[8] The self-help group and bank linkage is a medium to promote micro credit.

RELATED TERMS

Basel Norms

Basel norms are fixed by Bank for International Settlements. It is located in Basel, Switzerland. It acts as a coordinating agency for Central Banks of various countries. It is necessitated by globalization. Many banks operate internationally. These norms are for individual banks and Systemically Important Financial Institutions (SIFI). Its implementation is done by Central Banks of the respective countries. In India it is by RBI.

SIFIs are whose "… failure may trigger a relatively large number of simultaneous failures within the financial sector, and as a result, large losses to the entire economy".[9] It defines these institutions from the point of failure. Does it mean we can identify these institutions only after failure? The answer is yes and no. There is no pre known definition. At the same time there are few indicators to identify them. The financial institutions which are big in size, receiving short term funds and lending for long term purpose are prone to failure. These are few indicators based on which it can be identified. But these are not exhaustive indicators.

These norms are developed by Basel Committee on Banking Supervision (BCBS). So far three set of norms were developed. They are called Basel I, Basel II and Basel III. Basel I and II were implemented the Basel III is on implementation.

BIS describes Basel III norms as follows:

" 'Basel III' is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures."[10]

There are two components in Basel III. They are:

1. Capital
2. Liquidity

1. Capital

The capital consists of three pillars. They are:

Pillar 1: Capital, risk coverage and containing leverage

Pillar 2: Risk management and supervision

Pillar 3: Market Discipline

Pillar 1: Capital, risk coverage and containing leverage

Basel III norm fixed norms about type and quantum of each type of capital. This ensures the quality of capital. Capital is a liability the bank owes to investors. Capital norms are fixed in proportion to assets. Assets are the investments made by banks including loan. The total capital to risk weighted asset ratio must be at least 8% at all times.

The breakup of capital requirement is as follows:

1. Tier 1 Capital (6.0 %)
   a. Common Equity Tier 1 (4.5 %)
   b. Additional Tier 1(1.5 %)
2. Tier 2 Capital (2 %)

Tier 1 capital consists of the share capital and disclosed reserves or retained earnings. Share capital is the share investment made by public and others. Disclosed reserves or retained meanings means the undistributed profit. Common equity tier1 means the share capital held by common public.

Additional Tier 1 capital is investments that are debt in nature but do not have maturity period. It can be realised if the issuer wish to do so. Tier 2 capital is similar to additional Tier 1 capital but have maturity period of at least five years. Both of them have right to claim next to depositors and general creditors and they are neither secured nor guaranteed by issuer.

Over and above this 8 % there is a need to maintain Capital conservation buffer of 2.5 %. This capital can be withdrawn during financial stress but when the minimum capital requirement of the above said 8 % approaches the central bank can impose restriction regarding discretionary

7 Oxford Advanced Learners Dictionary
8 http://www.rbi.org.in
9 http://www.bis.org/bcbs/events/bhbibemoore.pdf
10 http://www.bis.org/bcbs/basel3.htm

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distribution of capital in the form of dividend and bonus. Usually the banks have the habit of indulging in this kind of discretionary distribution to show as if they are in strong position. To avoid this, restriction can be imposed.

During the period of high credit growth, on a temporary basis, the central banks can stipulate additional capital requirement to avoid unfettered credit growth which may result in credit bubble. It is called **Counter cyclical capital buffer.** Normally it can be from 0 to 2.5 % and there can be an add-on of 2.5 % more, in total 5 %. During normal time it must be zero.[11]

Leverage Ratio is part of the Pillar 1. It is the ratio between capital measure and exposure measure.

Leverage Ratio = Capital measure / Exposure measure

Capital measure means Tier 1 capital. Exposure measure means the assets created by banks and financial institutions. The total assets are adjusted to take care of some unusual exposures and after adjustments this exposure measure is arrived for this purpose. The banks are expected to maintain a leverage ratio of at least 3%.

Pillar 2: Risk management and supervision

It calls the banks to have an internal assessment process to assess the capital adequacy, risk exposure and to device risk management technique. It also calls central banks to have a review process to review banks.

Pillar 3: Market Discipline

Market discipline warrants disclosure of certain details like capital adequacy, risk exposure and risk assessment procedure. The disclosure of details should be on the line of details submitted to regulatory authority. It will bring transparency and give confidence to market participants.

2. Liquidity

The liquidity consists of two key principles. They are:

a) Liquidity Coverage Ratio (LCR)

b) Net Stable Funding Ratio (NSFR)

a) Liquidity Coverage Ratio

As per this norm a bank has to have adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to withstand liquidity crisis, if it happens, for a period of 30 days. Here, assets mean the investments made by banks including loan. It has to be implemented from the year 2016 starting with 60% coverage to 100% by 2019.

b) Net Stable Funding Ratio (NSFR)

It is the ratio between required stable funding and available stable funding.

NSFR = Available amount of stable funding/Required amount of stable funding

11 http://www.sidley.com/securities_and_financial_institutions_update_122110/

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The words stable funding indicates the maturity and certainty of funds. It should be of long term, stable and certain. Required fund indicates the liabilities and available funds indicate assets. It will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It means there should be a match between the nature of funding and nature of assets. It tries to avoid the practice of creating long term assets while getting short term funds. In a situation of mismatch the banks and financial institutions cannot honour the short term fund givers like depositors. As on April 2014, the consultative process in this regard is going on.

Non-Performing Assets (NPA)

A loan or advance is asset of the bank. If its interest or principle or both remain overdue (unpaid) for a reasonable period then it is called Non-performing asset. The reasonable period varies for various types of loans and advances. The reasonable period is determined by RBI.

As per RBI guidelines Non- performing asset (NPA) is a loan or an advance where;

1. interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

2. the account remains out of order' in respect of an Overdraft/Cash Credit (OD/CC),

3. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

4. the instalment of principal or interest there on remains overdue for two crop seasons for short duration crops,

5. the instalment of principal or interest there on remains overdue for one crop season for long duration crops,

6. the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken.

7. in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Mark-to-market value means of a derivative contract means the current market value of the derivative contract.

An asset which remained NPA for a period of 12 months or less is called **substandard asset**, an asset remained substandard asset for 12 months is called **doubtful assets**. A **loss asset** is one where loss has been identified by the bank or internal or external auditors of debtor or by RBI inspection as loss.

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CHAPTER 7

INDIAN FINANCIAL SYSTEM CAPITAL MARKET

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In this Chapter, I will learn

- COMPOSITION AND FUNCTIONS OF CAPITAL MARKET
- SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)
- TRADING PROCESS
- STOCK EXCHANGES
- DEVELOPMENT FINANCIAL INSTITUTIONS
- FINANCIAL INTERMEDIARIES
- RELATED TERMS

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Capital market is a medium and a platform for long term funds. It helps to generate bulk fund for government and industries. The institutions in the capital market are called Non-Banking Financial Companies. This is evident from RBI's observation which runs as: "Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/ sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs".[1] All the institutions listed in this observation are capital market institutions. But it is not necessary that all NBFCs are capital market institutions.

The RBI defines NBFCs as, "A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company)."[2] NBFCs are classified as deposit taking and non deposit taking NBFCs .The NBFC companies differ from banks in the following aspects:

(i) NBFCs can accept deposits but cannot accept demand deposits;

(ii) NBFCs are not a part of the payment and settlement system and they cannot issue cheques drawn on itself and

(iii) Bank deposits have insurance cover of Deposit Insurance and Credit Guarantee Corporation but it is not available for NBFC deposits.

This chapter covers composition and functions of primary and secondary market.

COMPOSITION AND FUNCTIONS OF CAPITAL MARKET

The capital market can be classified as shown in figure 7.1 in the next page.

Securities Market

Securities market deals with shares (equity shares, preference shares, derivatives) and debt instruments (bonds, debentures etc,.). Both **shares** and **debt** instruments are instruments of fund raising. But, there is a difference between them. In case of shares, the investors have a share in the capital and profit. In case of debt instruments, the investors do not have any share in the

1 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

2 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

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capital. They just lend to the company. The company is liable to pay interest on capital borrowed through bonds. Regardless of profit or loss, the debt instrument holders are entitled to receive interest income.

Debenture is also like bond but there is a slight difference.Bonds are unsecured one. It means there is no surety for bonds. The lender lends money to companies without any surety. In the case of debentures there is some surety. It may be plant, machinery or building etc.

Shares are of two types. One is Equity share and the other is Preference share. **Equity shares** are shares that has claim over capital, profit and loss. It means, the equity share holders have right to receive profit if the company earns profit and have to forego capital to the extent of loss in case the company incurs loss.

Preference shares are shares that have entitlement to a fixed amount of dividend or dividend at a fixed rate like that of interest on bonds. In the case of winding up (closing up) of company, these shares have the preferential right to get back the capital paid. They have the right to get back capital next to bond holders.

Government and Industrial Securities Market

Based on the fund raiser, we can classify securities market into two types. One is Government securities market and the other is Industrial Securities market.

Government Securities Market

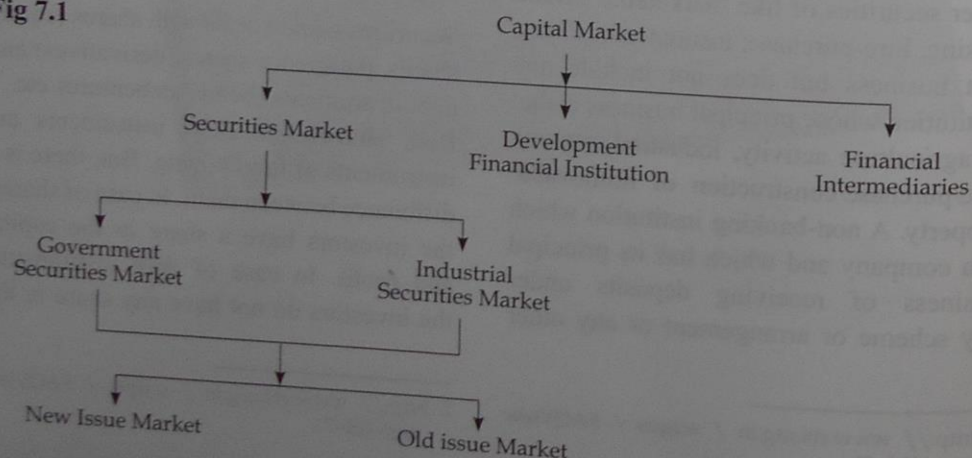
It is a market for Government and semi government securities backed by RBI.

It isalso known as Gilt Edged Market. Gilt edged means "of the best quality". The government securities are more reliable. That is why they are called Gilt edged securities.

Industrial Securities Market

It is a market for securities of industrial

Fig 7.1



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and commercial organisations.

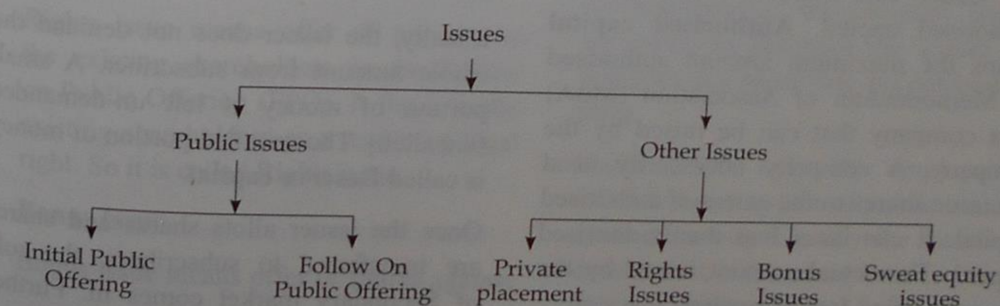
Both the Government securities and industrial securities are traded in primary as well as secondary market.

New and old issue market

Further, based on the nature of issue (in lay man's language issue means selling) the securities market can be classified as New issue market and Old issue market. The New issue market is also known as Primary market. The Old issue market also known as Secondary Market.

In new issue market, the securities issued by issuer are purchased by investors that are public. To put in another way, sale and purchase of new (fresh/ first time issued) securities is carried out. In old issue market the sale and purchase of securities that were already issued in the New issue market is carried out. In India, both New issue and Old issue markets are regulated by Securities and Exchange Board of India (SEBI).

Fig 7.2



SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

It was established in 1988 for the development and regulation of securities market through a resolution of government. It was given statutory status in 1992. Its head office is in Mumbai. Its regional offices are in Calcutta, Delhi and Chennai.

New issue Market

The issue of securities in new issue market can be classified as shown in the following figure 7.2.

Public and other issues

Public issue means issue of securities to public i.e to all people whoever wants to invest. In other issues the securities are issued to closed group of people.

Public issues

In new issue market, if any company or financial corporation (issuer) issues shares for the first time, it is called as Initial Public Offering (IPO).The issuer may be

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an existing company or corporation or may be a new start up. And if any company or corporation that has already issued shares, issues shares again, to raise additional fund it is called as Follow on Public Offering (FPO).

Issue Process

There are two ways of issuing securities in the New issue market. One is declared price issue and another is Book building issue. In the case of declared price selling, the issuer offers shares at a pre-fixed price. In **Book building**, the price is not announced. First, the issuer offers the shares and gets application from public and then based on the demand fixes the price. If the demand is high, the price is fixed high and vice versa.

In both IPO and FPO, the issuer usually does not directly issue the security. The issuer appoints any one **Merchant banker** on behalf of it to carry out fund raising activities. The merchant banker issues the application to investors and receives the application and money from investors. It sends the applications and money to issuer for allocation of shares to applied investors.

The issuer can issue to the extent of Authorised capital. **Authorised capital** means the maximum amount authorised by Memorandum of Association (MoA) of a company that can be raised by the company. A company necessarily need not issue shares to the extent of authorised capital. It can issue less than authorised capital. The actual amount issued by the issuer is called **Issued capital**.

After the company issues shares, the public subscribe (apply) to the shares. The subscription sometimes may be more than issued capital. If it is so, it means it is oversubscribed. The subscription sometimes may be less than issued capital. If it is so then it means it is undersubscribed. The actual amount subscribed is called **Subscribed capital**.

In the case of over subscription, the company allots shares to the subscriber based on some criteria. Usually, the small investors get preference. In this case the company can allot shares only to the extent of issued capital. In the case of under subscription, the company allots shares to all those who have applied. The remaining shares are purchased by underwriter. **Underwriter** means a financial intermediary who agrees to purchase the unsubscribed portion of issued capital.

The company usually collects the subscribed capital in installments. The portion of money demanded (called) from subscriber is known as **Called up capital**. The amount actually paid by subscribers when the money is demanded by issuer is known as **Paid up capital**.

Usually, the issuer does not demand the whole amount from subscriber. A small portion of money is left un-demanded (uncalled). The uncalled portion of money is called **Reserve capital**.

Once the issuer allots shares and shares are transferred to subscribers, the role of Secondary market comes in. Further

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selling and buying of these shares takes place in Secondary market. Before looking into Secondary Market, let us continue with Primary market.

Other Issues

The issues that are not issued to public and issued to a closed group of people can be classified as other issues.

Private Placement

Private placement means offering shares directly to the financial institutions, mutual funds and high worth investors.

Private placements are made to Qualified Institutional Buyers (QIB). **Qualified institutional buyers** are those who are deemed financially sophisticated and are recognised by security market regulator to need less protection from issuers than most of the public investors. Institutions like Mutual funds, Financial Institutions (FIs), scheduled commercial banks, insurance companies, provident funds, pension funds, State Industrial Development Corporations etc., fall under the definition of being a QIB.

Rights Issue

Rights issue means offer of security to the existing shareholders in the Follow on Public Offering (FPO). It flows to the existing shareholders as a matter of legal right. So it is called Rights issue.

Bonus Issue

Bonus issue means offer of shares against distributable profit to existing shareholders. The shareholders' share in the profit is converted as shares. It is also known as scrip issue or capitalization issue.

Sweat Equity Issue

Sweat equity issue means offer of shares to employees or Directors of the company which issues shares as recognition of their hard labour (sweat) which results in contribution to the company in the form of intellectual property rights, technical know- how etc. It is usually issued at a discounted price. The Companies act 1956 observes as follows: "sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called."

There are two other ways of incentivizing the employees and directors of the company. They are Employees Stock Option Scheme (ESOS) and Employees Stock Purchase Scheme (ESPS). Under the ESOS the whole-time Directors, Officers or employees of the company are given an option to purchase the shares of the company at a future date at a predetermined price.

Under ESPS only the employees are offered shares as part of public issue or in some other way. Usually the share cost is deducted from the salary between the offer date and purchase date.

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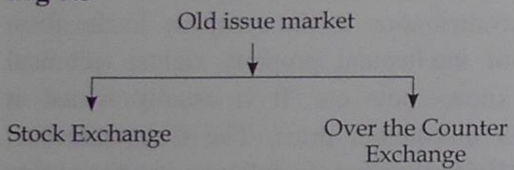
Old Issue Market

As already said, Old issue/Secondary market is a medium for buying and selling of securities issued in the New issue market. Stock exchange is synonymously used for Old issue market. But it is wider than that. There are two trading media in this as shown in figure 7.3.

Fig 7.3



Stock Exchange

Stock exchange is an institution for orderly buying and selling of listed securities. Listed securities means the securities accepted to be traded in stock exchanges.

Over the Counter Exchange

Over the counter exchange is a platform for trading in securities that are not 'listed' on a recognised Stock exchange.

TRADING PROCESS

The trading of shares in stock exchanges is mediated by stock broking companies. Both buyer and seller have to approach broker. **Brokers** are registered members with stock exchanges to trade on behalf of clients. **Sub-brokers** are trading persons affiliated with Brokers. They act like branches to Brokers. They are subject to SEBI guidelines.

The types of trading are different based on time. In **Cash trading**, the sale and purchase of securities takes place in the prevailing price on the day of trading. In **Forward trading**, both buyer and seller agree to buy and sell respectively at a future date at a pre agreed price, irrespective of the price that prevails on the day of trade. There are two types of forward trade. One is **Futures** and another one is **Options**. Though both are forward trade methods, there is a slight difference. In case of Futures, both buyer and seller have to execute the agreement. In case of Options, the buyer or seller can withdraw from the agreement. To have this option the buyer or seller has to deposit some amount as premium. In the case when he fails to execute the agreement, he has to forego the premium amount. The choice available to seller not to execute the agreement is called **Put option**. If it is available to buyer it is called **Call option**.

The futures and options are **Derivatives**. Derivatives mean any agreement like futures and options which doesn't have independent value. The agreement to trade in the future doesn't have any value. It has value only because of underlying securities which are to be traded.

STOCK EXCHANGES

In India, there are small and big stock exchanges. The most prominent exchanges are National Stock Exchange (NSE) and Bombay Stock Exchanges (BSE).

National Stock Exchange (NSE)

It was established in 1993 on the

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recommendation of Pherwani Committee. Industrial Development Bank of India (IDBI) is the main promoter of this exchange. Other leading Financial Institutions are also promoters of it along with IDBI.

Bombay Stock Exchange (BSE)

It was established in 1887.It is Asia's oldest Stock Exchange. It was known as 'The Native Share and Stock Brokers Association'. It was owned by stock brokers. Now it is demutualised. Demutualised means the stock brokers owned organisation made public owned organisation. The shares in the hands of brokers were transferred to public. This process is called **Demutualisation**.

Index

Like wholesale price index which measures the rise/fall in the price of commodities, there are share price indices. The most prominent indices in India are Sensex, Nifty and Nifty Junior.

Sensex stands for **Sens**itive **index**. This is an index of Bombay stock exchange. This measures the price movement of top 30 company shares. The top 30 companies are called Blue chip companies.

Nifty stands for **N**ational **I**ndex for **fifty**. This and Nifty Junior are indices of National stock exchange. NIFTY measures price movement of top fifty companies. Nifty Junior is an **index** of next 50 top companies.

The top companies are selected on the basis of total value of all shares that are traded in the stock exchange.

Value of traded shares = Price of one share x Number of shares traded

This value is called **free float market capitalisation**. The value of all {both traded and non-traded (the shares that are kept for a long time)} shares is called **market capitalisation**.

Market capitalisation is the value of shares that were sold to public which are called outstanding shares. In formulaic form:

Market capitalisation = Price x Total outstanding share

For example if the price of a share is ₹ 200 and the total outstanding share of that company is 2000 then market capitalisation is 200 x 2000 = ₹ 400000. The price mentioned here is not actual price but price estimated on the basis of future prospects of the company and economic condition etc.

Depositories

Depositories are institutions that keep securities of investors in electronic format (demat format). Demat stands for **de-materialised**. It means securities that were kept in paper (material) format now made as dematerialised (electronic) one. This electronic format is stored and maintained by these Depositories. The change in ownership, whenever transfer of securities takes place, is done electronically. In India,

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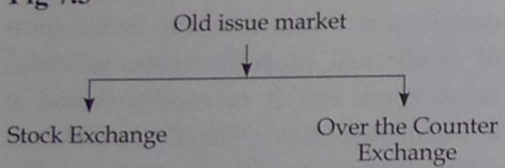
Old Issue Market

As already said, Old issue/Secondary market is a medium for buying and selling of securities issued in the New issue market. Stock exchange is synonymously used for Old issue market. But it is wider than that. There are two trading media in this as shown in figure 7.3.

Fig 7.3



Stock Exchange

Stock exchange is an institution for orderly buying and selling of listed securities. Listed securities means the securities accepted to be traded in stock exchanges.

Over the Counter Exchange

Over the counter exchange is a platform for trading in securities that are not 'listed' on a recognised Stock exchange.

TRADING PROCESS

The trading of shares in stock exchanges is mediated by stock broking companies. Both buyer and seller have to approach broker. **Brokers** are registered members with stock exchanges to trade on behalf of clients. **Sub-brokers** are trading persons affiliated with Brokers. They act like branches to Brokers. They are subject to SEBI guidelines.

The types of trading are different based on time. In **Cash trading**, the sale and purchase of securities takes place in the prevailing price on the day of trading. In **Forward trading**, both buyer and seller agree to buy and sell respectively at a future date at a pre agreed price, irrespective of the price that prevails on the day of trade. There are two types of forward trade. One is **Futures** and another one is **Options**. Though both are forward trade methods, there is a slight difference. In case of Futures, both buyer and seller have to execute the agreement. In case of Options, the buyer or seller can withdraw from the agreement. To have this option the buyer or seller has to deposit some amount as premium. In the case when he fails to execute the agreement, he has to forego the premium amount. The choice available to seller not to execute the agreement is called **Put option**. If it is available to buyer it is called **Call option**.

The futures and options are **Derivatives**. Derivatives mean any agreement like futures and options which doesn't have independent value. The agreement to trade in the future doesn't have any value. It has value only because of underlying securities which are to be traded.

STOCK EXCHANGES

In India, there are small and big stock exchanges. The most prominent exchanges are National Stock Exchange (NSE) and Bombay Stock Exchanges (BSE).

National Stock Exchange (NSE)

It was established in 1993 on the

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recommendation of Pherwani Committee. Industrial Development Bank of India (IDBI) is the main promoter of this exchange. Other leading Financial Institutions are also promoters of it along with IDBI.

Bombay Stock Exchange (BSE)

It was established in 1887.It is Asia's oldest Stock Exchange. It was known as 'The Native Share and Stock Brokers Association'. It was owned by stock brokers. Now it is demutualised. Demutualised means the stock brokers owned organisation made public owned organisation. The shares in the hands of brokers were transferred to public. This process is called **Demutualisation**.

Index

Like wholesale price index which measures the rise/fall in the price of commodities, there are share price indices. The most prominent indices in India are Sensex, Nifty and Nifty Junior.

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there are two depositories one is National Securities Depository Limited (NSDL), Mumbai and other is Central Depository Services India Ltd (CDSL), Mumbai.

National Securities Depository Limited (NSDL) is the first Depository in the country. It was established by UTI, NSE and IDBI. Central Depository Services India Ltd (CDSL) was established by BSE, Bank of India, Bank of Baroda, SBI and HDFC Bank.

Clearing Houses

Clearing houses enable easy settlement of securities trade. Like Depositories it also helps in change of ownership and delivery of securities.

Clearing Banks

Clearing banks mediate fund transfer between buyers and sellers. Both securities and fund transfer are made through National Securities Clearing Corporation of India Limited (NSCCL). It mediates between various depositories, clearing houses and clearing banks in settlement of securities and funds respectively. The schematic figure 7.4 explains this.

Securities paid by the delivering member to the clearing house/Depository on morning of T+ 2

Funds are paid-in to the clearing bank by the Receiving Member on morning of T+2.

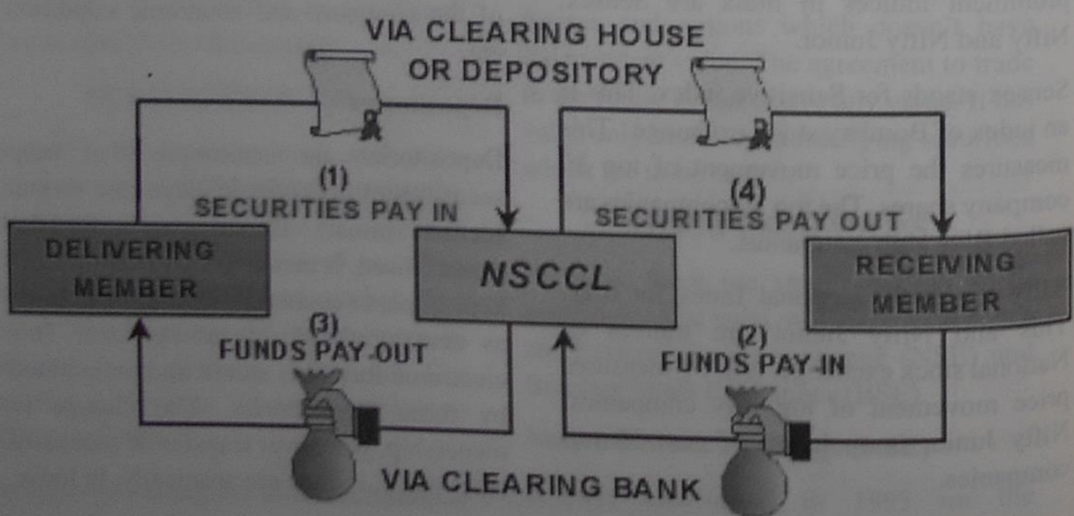
The pay-out for both funds and securities takes place evening of T+2.

Source: http://otcei.net/clearing/

Rolling Settlement

In the above explanation to the diagram, T+2 represents Rolling settlement. Rolling

Fig 7.4



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settlement means the trade executed in securities market is settled in few subsequent working days. T stands for trade day, the day on which buyers and sellers agree to buy and sell. The number 2 represents two working days after the trade day in which settlement, that is delivery of securities and funds, takes place which is called settlement day.

Online Trading

The trading of shares is now made online. The online trading platform of Bombay is BOLT (BSE Online Trading) and of NSE is NEAT (National Exchange Automated Trading).

DEVELOPMENT FINANCIAL INSTITUTIONS

Development financial institutions provide long term loan (even more than 25 years) and entrepreneurial assistance to industries. The entrepreneurial assistance is in the form of technical advice, helping in feasibility study etc.

In India IDBI, Industrial Financial Corporation of India (IFCI), Exim Bank etc,. are some of the development financial institutions to be named.

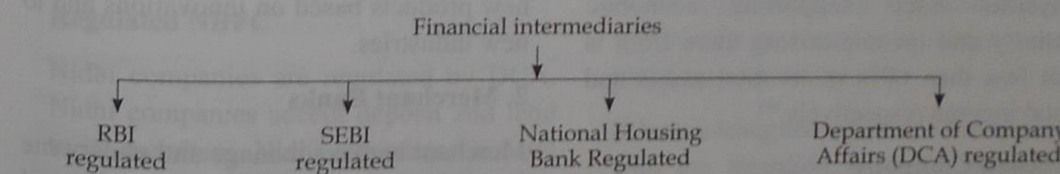
FINANCIAL INTERMEDIARIES

The capital market institutions other than stock exchanges and development financial institutions can be called as Financial Intermediaries. The financial intermediaries can be classified as shown in the following figure 7.5

RBI Regulated NBFCs

RBI regulated NBFCs were initially classified as

Fig 7.5



(i) Equipment leasing company

(ii) Hire-purchase company

(iii) Loan company

(iv) Investment company

i. Equipment leasing company

Equipment leasing companies own machineries and equipment and lease them to clients. In return the equipment leasing companies get rental income.

ii. Hire-Purchase Company

Hire purchase means purchasing equipment, machinery etc., in installment payment system. Hire purchase companies finance this kind of purchase and recover

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money from clients in installment.

However, with effect from 6th December, 2006 the above NBFCs registered with RBI have been reclassified as:

1. Asset finance company (AFC)

2. Loan company (LC)

3. Investment company (IC)

1. Asset Finance Company

The RBI website defines AFCs as follows: "AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/ economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipment, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/ physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively."[3]

2. Loan Company

The main business of Loan companies is lending. They provide car loans, mortgage loans, gold loans etc.

3. Investment Company

Investment companies are the companies which invest in shares to acquire stake in other companies to earn profit and not for the purpose of trading. To qualify as investment companies, their main business should be investment and major part of the income should come from investment.

SEBI regulated NBFCs

1. Venture Capital Fund

2. Merchant Banking companies

3. Stock broking companies

1. Venture Capital Companies

Usually the financial institutions are hesitant to finance new products because the profitability of new products is uncertain and involve risks. So, to finance such products, separate type of financial companies who venture to finance them are established. They are called Venture capital companies. The venture capital companies provide capital to companies that produce new products based on innovations and to new industries.

2. Merchant Banks

Merchant bankers manage and underwrite new issues, provide Consultancy and Corporate advisory Services for corporate clients on raising funds and other financial aspects. In India, merchant banking services are carried out by commercial banks. The merchant banks are also called as Investment Company.

Merchant Banker has been defined under the Securities and Exchange Board of India (Merchant Bankers) Rules, 1992 as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

3 http:// www.rbi.org.in / scripts / FAQView aspx?Id=71

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3. Stock Broking Company

Stock broking companies are those who are registered with and recognised by SEBI to mediate or help investor in buying and selling of securities. The broking companies charge for mediation. It is called brokerage charge.

NHB Regulated NBFC

Housing loan companies are regulated by National Housing Bank. Housing loan companies finance construction and purchase of house.

Department of Company Affairs (DCA) Regulated NBFC

Nidhi companies are regulated by DCA. Nidhi companies accept deposit and lend to its members. Nidhi companies are not regulated exclusively by DCA. Only the administrative matters are controlled by it and deposit and lending norms are regulated by RBI. Nidhi companies, therefore have two regulators:

1. The Department of Company Affairs (DCA)

2. The Reserve Bank of India (RBI)

RELATED TERMS

Face Value and Issue Price

Face value is the actual value of shares. Issue price means price of share including share premium. Premium means extra price a share claims in the market due to high demand for it. For example the face value of share may be ₹ 10 but due to high demand the share can be issued at say ₹ 700. Here the share premium is ₹ 690. The thing to be noted is the companies announce dividend only on face value. In this case, if a company says dividend is 23% it means 23% of ₹ 10.

Short Selling

In short selling, the seller sells the securities without owning the securities. He borrows the securities and sells it.

Bull and Bear Trading

In bull trading, buyers buy more shares in the expectation that the securities price will rise in the future with a plan to sell at that time and earn profit.

In bear trading the sellers sell the securities, with the intention to avoid loss, in the expectation that the security prices will fall.

They are named after the animal sprit of bull and bear. The bull throws up the lives which it attacks and bear grounds the live which it attacks. So rise (up) in price is associated with bull and fall (down) in price is associated with bear.

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Securitisation

Securitisation is the method of converting existing assets into securities. Take the case of banks, their unrecovered loans are considered as Non- performing assets (NPA). These assets are sold to Asset Reconstruction Companies (ARCs). The asset reconstruction company divides the total assets into equal parts and sells to investors. The investors are entitled to flow of interest income from these assets and principal amount when repaid.

Buy Back

Buy back means the issuer buying the securities again to accumulate share in his hands.

Market Capitalisation - GDP Ratio

It is called as MC-GDP ratio. It is the ratio between total market capitalisation of all stock exchanges and GDP of the country.

Price Earnings Ratio

Price earnings ratio is the ratio between price of the share and earning (dividend income/ profit)per share.

Price earnings ratio = Price per share (P) / Earnings per share (E)

Net Asset Value (NAV)

Net asset value is the net value of the outstanding shares. Net value means the total asset value minus liabilities of the Mutual Fund. Total asset value means the total number of shares and price per share in the market.

Total asset value = Total number of shares x Price per share in the market.

Net asset value = Total asset value - liabilities

High Net Worth Individual (HNI)

High net worth individuals are those who have net financial asset of at least $1 million and those who have net worth at least $30 million financial asset are called **ultra-high net worth individuals**.

Transferable and Non-Transferable

Securities are of two types. One is transferable and another one is non-transferable. The term non-transferable is often seen in our day to day life. In bus tickets and train tickets we can see these words 'non -transferable. It means that we cannot sell it to others. To put it in another way, we cannot change the ownership of these tickets. Likewise, in case of securities, if it is transferable we can change the ownership and in case of non-transferable securities the ownership cannot be changed.

Cumulative and Non-cumulative Shares

Cumulative shares means the shares are entitled to receive dividends of a particular year in the coming years as arrear if the company didn't give dividend in that particular year. Non- cumulative shares don't have that right.

Convertible- Non Convertible Securities

Convertible means one kind of securities can be converted into another kind of securities. For example, the bonds can be converted as shares. In the case of Non-convertible securities, this is not possible.

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Mutual Funds (MFs)

While merchant banker primarily helps issuer, the Mutual funds help investors. The mutual funds mobilise the savings of the people and invest in securities. The individuals lack expertise in stock market and have very small amount to invest. So the mutual funds collect money from public and create a large pool of money and with their expertise they invest in securities. They invest in product called Units. Units are made up of more number of securities.

The shares of various companies are pooled together. For example 10 shares of ten companies (totally 100 shares) are pooled together. The value of share of each company may be different. Assume that the total value of 100 shares is ₹ 7000. This may be divided into units of ` 10 each. So, totally 700 units are available. It means each unit has a small portion of all the 100 shares. The investor money is invested in these units. Their return depends on growth of all the 100 shares. In this way of investment, the small amount of money gets invested in many shares and not in single share. So the risk is spread out.

Hedge Funds

Hedge funds are similar to Mutual Funds. But in the case of Mutual Funds the fund is collected from public and invested by Mutual fund which is created by somebody else where as incase of Hedge Funds it is not public but a hand full of investors join together and form fund of their own and invest in different securities and use different investment strategies. These investors are financially well and are sophisticated investors. So, they do not need protection of SEBI and they are unregistered and unregulated.

Offer for Sale (OFS)

Offer for sale is also like FPO. While the FPO was to raise additional fund requirements the OFS is to dilute the shareholding of promoters in a listed company. As per the Securities Contract Regulations (Rules) 157 at least 25 % of all type of securities issued by a listed company should be in the hands of Public. To meet this requirement the companies approach public to sell their shares through OFS.

A Note on Commodity Exchange

The commodity exchange is a platform to buy and sell agricultural products, natural resources like iron ore, crude oil and precious metals like gold and silver.

There are many regional exchanges and six national exchanges. They are Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), National Multi-Commodity Exchange (NMCE) and Indian Commodity Exchange (ICEX), the ACE Derivatives Exchange (ACE) and the Universal

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commodity exchange (UCX). The apex body for these exchanges is Forward Markets Commission (FMC).

The commodity exchange is more akin to stock exchange. The concepts used in stock exchange and commodity exchanges are same. For example Derivatives trading exist in both the exchanges. In both the exchanges it carries same meaning.

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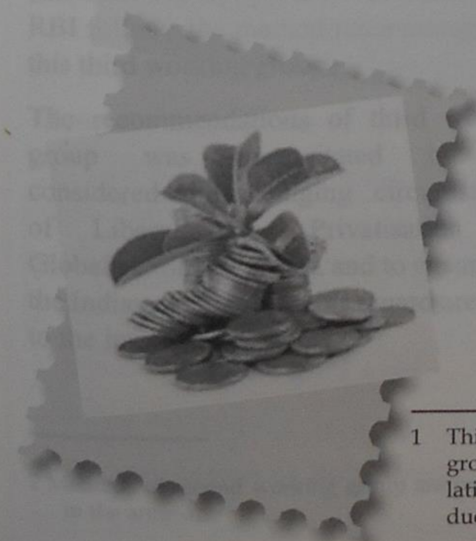
CHAPTER 8

MONEY STOCK MEASURES[1]



1 This chapter heavily draws its content from Report of Working group on 'Money Supply: Analytics and Methodology of Compilation' and an article named New monetary aggregation: An introduction, RBI Bulletin October 1999.

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CHAPTER 8

MONEY STOCK MEASURES

In this Chapter, I will learn

- SECTORISATION OF THE ECONOMY
- MONETARY AND LIQUIDITY AGGREGATES
- ANNEXURE

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Money stock means the total amount of money available in an economy at a particular point of time. It is also called money supply. The money supply measure is necessary because the amount and nature of money supply has greater influence and impact in the economy.

Reserve Bank of India, the monetary authority of India, has a long tradition of publishing monetary statistics dating back to July, 1935. The method of compilation of monetary data had undergone revision three times. The methodological changes were made on the recommendation of working groups formed by RBI. The first working group was formed in 1961 and the second working group was formed in 1977[2] (Annexure). The third working group (Working group on money supply: Analytics and Methodology of Compilation) was formed in the year 1997 under the chairmanship of Dr. Y. V. Reddy (the then deputy governor of RBI). Now, RBI follows the method recommended by this third working group.

The recommendations of third working group was necessitated by and considered the changing circumstances of Liberalisation, Privatisation and Globalisation (LPG) era and to ensure that the Indian standards in this regard are close to the international ones.

2 Methods of second working group are provided in the annexure

Money

Before getting into the methods of third working group, it is necessary to know what money is. Money does not include coins and currencies only. It includes other financial assets too. But there is difference among economists in the definition of money and the financial assets to be included in the category of money. The third working group observes, "There is no unique definition of 'money', either as a concept in economic theory or as measured in practice……… money has to have relationship with the activities that economic entities pursue. Money can, therefore, be defined for policy purposes as set of liquid financial assets, the variation in the stock of which could impact on aggregate economic activity."

The money is classified into different types of financial assets based on their liquidity. Liquidity means the ease at which we can spend a financial asset. For example the currency at hand can be spent very easily. The currency deposited in banks can't be spent easily like that of the currency at hand because we have to go to bank or ATM to draw money and then only we can spend it. It involves some delay and manual labour. So, it is considered less liquid than currency at hand.

SECTORISATION OF THE ECONOMY

For the purpose of the compilation of monetary and liquidity aggregates, the third working group divided the economy

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into domestic sector and rest of the world. The domestic sector was further divided into four exclusive sectors, viz.,

1. Households

2. Non-financial commercial sector

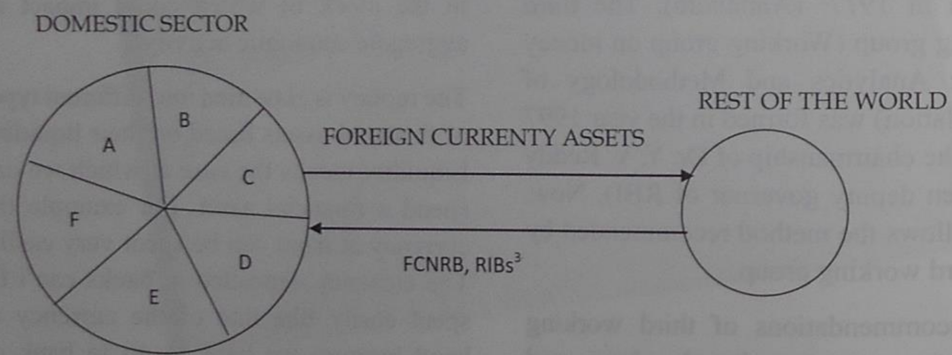
3. General government

4. Financial corporations

The financial corporation sector comprises banking sector, consisting of the RBI and the banking systems in India and the other financial corporation sector. The other financial corporation sectors comprises development financial institutions such as term lending institutions and refinancing insurance corporations, Mutual funds and non banking financial companies accepting deposits from the public.

The domestic sector can also be classified as money issuing sector and money holding sector. Money issuing sector comprises RBI and Banking systems in India. Money holding sector comprises Households, other financial corporations and non-financial commercial sector. This is represented in chart 8.1

Chart 8.1: Sectorisation of the Economy for Money Supply Compilation



A:HOUSE HOLDS	
B: RBI	B+C : BANKING SECTOR
C: BANKING SYSTEMS IN INDIA	B+C+D : FINANCIAL CORPORATIONS SECTOR
D:OTHER FINANCIAL CORPORATIONS	

E: GENERAL GOVERNMENT	B+C: MONEY ISSUING SECTOR
F: NON-FINANCIAL COMMERICAL SECTOR	A+D+F: MONEY HOLDING SECTOR

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MONETARY AND LIQUIDITY AGGREGATES

The third working group recommended two different financial aggregates namely, Monetary Aggregates and Liquidity Aggregates. The working group observes: "The partition between monetary and liquidity aggregates has been dictated by the fact while the first relates only to monetary liabilities of the central bank and depository corporations', i.e. the banking system, the latter also includes select items of financial liabilities of non-depository corporations, such as development financial companies and non-banking financial companies accepting deposits from the public apart from post office savings."

The development finance institutions which do not accept time deposit from public is called non-depository corporations.

Liquidity Aggregates include more number of financial assets than that is included in the Monetary Aggregates.

Monetary Aggregates

The new monetary aggregates are of four types. They are:

1. Reserve money or Base money (M_0)

2. Narrow money (M_1)

3. Intermediate money (M_2) and

4. Broad money (M_3)

1. Reserve Money or Base Money (M_0)

The financial assets in the M_0 category is called reserve money because these are held in reserve either by public and banks (Currency in Circulation) or by the RBI (Bankers Deposits with the RBI + Other Deposits with the RBI) and these are not available for the lending purpose of banks.

M_0= Currency in Circulation + Bankers Deposits with the RBI + Other Deposits with the RBI

Currency in circulation is the total amount of the Rupee notes issued by RBI and the Rupee coins and small (paisa) coins issued by Government of India. Currency in circulation is equal to the total of the currency held by both public and banks. Bankers deposit with RBI includes Cash Reserve Ratio (CRR) and excess reserve. The banks keep CRR with RBI as stipulated by the latter. Some banks keep more cash reserve with RBI than stipulated amount. It is called **Excess Reserve**.

Other deposits with RBI comprise mainly

Deposits of quasi-government and other financial institutions including primary dealers

Balances in the accounts of foreign central banks and governments

Accounts of international agencies such as the IMF etc, and

Provident, gratuity and guarantee funds of RBI staff

Primary dealers are financial intermediaries operating in Government securities (G-Secs) and other financial instruments.

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2. Narrow Money (M_1)

The financial assets included in the category of M_1 are fewer than those included in the category of M_2. That means, it defines money in a narrower sense. So, it is called Narrow Money.

M_1 = Currency with the Public + Demand Deposits with the Banking System + Other Deposits with the RBI.

Currency with the public is equal to currency in circulation minus cash on hand with the banking system.

Demand deposits are those deposits that can be withdrawn by depositor at any point of time.

There are two major types of demand deposits viz., current deposits and saving deposits. The saving deposits have two components namely demand liability and time liability. Most part of the saving deposits is demand liabilities only. But few saving deposits can be withdrawn only on some performance or on some happenings. For example a saving deposit made in the name of a child may be deposited with a condition that it can be withdrawn only after the child become a major. This is an example for time liability portion of saving deposits.

In M_1, only demand liability portion is included. So, the above equation can be rewritten as follows:

= Currency with the Public + Current Deposits with the Banking system + Demand liabilities portion of Saving Deposits with the Banking System + Other Deposits with RBI.

The Second working group had apportioned saving deposits into demand and time liabilities on the basis of interest application on such deposits. This practice is continued by the third working group also.

3. Intermediate Money (M_2)

It is called intermediate money for the reason financial assets included in this category are more than those included in M_1 but less than those included in M_3.

M_2 = M_1 + Time Liabilities portion of savings Deposits with the Banking system + Certificates of Deposit issued by Banks + Term Deposits (excluding Foreign Currency Non-Resident (Bank) (FCNR (B)) Deposits) up to one year maturity with the Banking system.

It can be rewritten as follows:

= Currency with the public + Current Deposits with the Banking System + Savings deposits with the banking system + Certificates of deposits issued by Banks + Term Deposits with the Banking System + Term Deposits (excluding FCNR (B) deposits) up to and including one year maturity with the banking system + Other deposits with the RBI.

4. Broad Money (M_3)

The financial assets included in the category of M_3 are more than those included in the category of M_2. That means, it defines money in a wider sense. So, it is called Broad Money.

M_3 = M_2 + Term Deposits (excluding FCNR (B) Deposits) over one year maturity with the Banking system + Call borrowings from 'Non – Depository' Financial Corporations by the banking system.

Liquidity Aggregates

L_1 = M_3 + All Deposits of Post office Savings Banks excluding National Savings Certificates (NSCs)

L_2 = L_1 + Term Deposits with Term Lending Institutions and Refinancing Institutions (FIs) + Term borrowing by FIs + Certificates of Deposit issued by FIs

L_3 = L_2 + Public Deposits of Non-Banking Finance Companies (NBFCs)

Money Multiplier (Mb)

Money multiplier is the ratio between Broad money (M_3) and Reserve money (M_0)

$M_b = M_3 / M_0 = M_3 \times 1/M_0$

It means the M_3 will get multiplied by $1/M_0$ times. For example, if Reserve Money is 20%, $1/M_0$ will be 5 (1/20 x 100 = 5). Then M_3 will get multiplied 5 times in the economy. It means money supply will increase 5 times.

ANNEXURE

RBI followed the following method since 1979 till implementation of current method.

M_1 (Narrow Money)

M_1 = Currency with the Public + Demand Deposits of banks + Other demand deposits with RBI

M_2 (Intermediate money)

M_2 = M_1 + Post office Savings Deposits

M_3 (Broad Money)

M_3 = M_1 + Time Deposits of the Public with Banks.

M_4

M_4 = M_3 + Total Post office deposits.

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CHAPTER 9

INFLATION AND DEFLATION

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In this Chapter, I will learn

- INDEX
- INFLATION
- WEIGHTED INDEX NUMBERS
- OLD CONSUMER PRICE INDICES
- NEW CONSUMER PRICE INDICES
- TYPES OF INFLATION
- EFFECTS OF INFLATION
- MEASURES TO CONTROL INFLATION
- RELATED TERMS

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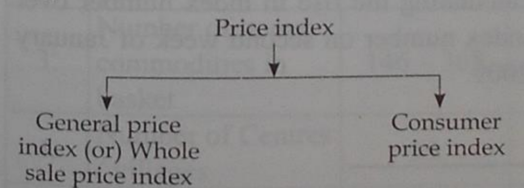
The word 'Inflation' is often heard and seen in media. It is an important problem for policy makers, politicians and common people. Inflation assumes such an importance due to its all round implications. In contrary deflation is less heard because this is a rare phenomenon. So inflation deserves elaboration.Before getting in to the subject matter of inflation it is better to look into index numbers and price indices first.

This chapter covers index, measurement of inflation, weighted index numbers, types of inflation, impact of inflation, measures to control inflation and related terms.

INDEX

An Index number may be described as a specialized average designed to measure the relative change in the level of a phenomenon from time to time. S.P. Gupta observes "An index number is a specialized average designed to measure the change in a group of related variable over a period of time".[1]

Fig 9.1



1 Statistical Methods S.P. Gupta, p. 516

Price Index

Price index is a specialised average that measures the changes in prices over a period of time. The price indices are of two types as shown in the figure 9.1.

General Price Index (GPI)

General Price Index measures the changes in average prices of goods and services. A base year is selected and its index is assumed as 100 and on this basis, price index for further period is calculated.

Consumer Price Index (CPI)

Consumer Price Index measures the average change in prices paid by ultimate consumers for a particular basket of goods and services over a period of time. CPI actually measures the increase in prices a consumer will have to pay for the designated commodity basket (which may be revised every four-five years to factor in changes in consumption pattern).[2]

Construction of Price Index

Price index is calculated by measuring rise in price of current year over price of base year.

Price Index = Current year's price / Base year's Price X 100

$= P_1 / P_0 X 100$

2 Economic survey 2008-09, p. 63

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Example:

Take 2004-05 as base year.

Price of rice in 2004-05, ₹ 2/kg

Price of rice in 2005-06, ₹ 3/kg

Price of rice in 2006-07, ₹ 3.50/kg

Price Index for 2005-06 = Price of rice in 2005-06/ Price of rice in 2004-05 X 100

= 3/2 X100

= 150

Price index for 2006-07 = Price of rice in 2006-07/ Price of rice in 2004-05 X 100

= 3.50/2 X100 = 175

INFLATION

Shapiro defines inflation as "persistent and appreciable rise in the general level of prices"[3]. The economic survey of 2008-09 observes inflation as "... an upward movement in the general prices of goods and services and is estimated as the percentage rate of change in a price index over the reference time period".

Measurement of Inflation

Inflation is measured with the help of general or wholesale price index in India.[4] The percentage of rise in the price index of a particular period from previous period price index is the rate of inflation.

Inflation = current period price index – last period price index / last period price index*100

In the above example,

Inflation[5] in the year 2006-07

= 175 – 150/150 x 100

= 16.6%

This is a simple index based calculation. Actually, inflation is calculated on the basis of weighted index numbers.

Note: Base year is used only to calculate the index number. The inflation is calculated as a percentage of rise in index number over last year.

Year-on-Year Inflation

Year–on-year inflation means rate of change of inflation over the corresponding period (week or month or quarter in relation to the frequency of the data) of the previous year. For example, the inflation on second week of January 2010 is computed by calculating the rise in index number over index number on second week of January 2009.

3 Monetary Economics, 5th revised edition , M.L. Jhingan p.232

4 The International Monetary Fund (IMF) statistics reveals that 24 countries use WPI as the official measure to track inflation, compared to 157 countries which use CPI

5 Officially Laspeyres's formula is used in index construction but for the simplicity a simple formula without weightage is used

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WEIGHTED INDICES

In India various weighted price index are calculated. They are:

1. Wholesale Price Index (WPI)
2. Consumer Price Index for Industrial Workers (CPI – IW)
3. Consumer Price Index for Urban Non – Manual Employees (CPI – UNME)
4. Consumer Price Index for Agriculture Labourers (CPI – AL)
5. Consumer Price Index for Rural Labourers (CPI - RL)

Among the above indices, until October 2009, only the WPI was used to calculate inflation and made public through the newspapers. So, it is called the **head line inflation.** The other indices were published only as index numbers and not as inflation. But now the inflation is also calculated based on new CPI indices. The new CPI indices are elaborated later.

The weights are assigned on the basis of wholesale transaction (value of quantities) for respective commodity groups for WPI. For other indices, the weights are assigned on the basis of consumer expenditure survey.

For example, in the wholesale market, out of the total transaction (value of quantities) 20.118 % of the transaction takes place in primary products in the base year. So, primary commodities are assigned 20.118

Table 9.1 Salient Features Of Price Indices

S.No			CPI-UNME	CPI – IW	CPI – AL	CPI- (RL)	WPI
1.	Weights allocated on the basis of		Consumer Expenditure Survey				Whole Sale Transactions
		First	1958 – 59	1958 -59	1956 – 57	1983	
		Latest	1982 – 83	2001	1983	1983	
2.	Base year of the Current Series		1984 – 85	2001	1986 -87	1986 -87	2004-05
3.	Number of items/ commodities in basket		146 – 365	120 -160	260	260	676
4.	Number of Centres / villages		59	76	600	600	5482 Quotations
5.	Time lag of the index		2 weeks[6]	1 month	3 weeks	3 weeks	3 weeks
6.	Frequency		Monthly	Monthly	Monthly	Monthly	Monthly

Source: Economic survey 2006-07 and Ministry of commerce and industry

% weight. In consumer expenditure survey, it was found that people spend 46.19 % of their total expenditure on food in the base year. So, food items are assigned with 46.19% weight.

Reason for Assigning Weight

Weights are assigned to arrive at a realistic inflation rate. 20.118% weight means if we take 177.77 points of price rise, only 35.76 points (20.118 X 177.77/100 = 35.76) of price rise get increased in the budget of a wholesale purchaser, because out of his whole purchase, he spends only 20.118% on primary commodities.

The following table 9.1 in the next page gives the details of various price indices regarding base year, number of commodities included, frequency of publication etc.

Whole Sale Price Index (WPI)

This index measures the change in the price of commodities traded in the wholesale market. The following table gives details about weights assigned to different commodity groups within WPI.

Table 9.2 Table showing commodity groups, weight and no. of articles

S.No	Commodity Groups	Weight	No. of Articles
1	Primary Products	20.118	102
2	Fuel, Power, Light & Lubricants	14.91	19
3	Manufactured Products	64.97	555
	Total	100.00	676

The Authority responsible for Compilation and Release: Office of the Economic Advisor, Ministry of Commerce & Industry.

OLD CONSUMER PRICE INDICES

Before February 2011, India had only four consumer price indices viz. Consumer Price Index for Industrial Workers (CPI – IW) , Consumer Price Index for Urban Non – Manual Employees (CPI – UNME), Consumer Price Index for Agriculture Labourers (CPI – AL) and Consumer Price Index for Rural Labourers (CPI - RL).

CPI for Industrial Worker (CPI (IW))

This index measures the change in the price of commodity basket consumed by the industrial workers. The following table shows the weights for different commodities group in this index.

Table 9.3 Product groups and weightage of CPI (IW)

S.No	Groups	Weights
1.	Food	46.19
2.	Pan, Supari, Tobacco & Intoxicants	2.27
3.	Fuel & Light	6.43
4.	Housing	15.27
5.	Clothing, Bedding&Foot wear	6.58
6.	Miscellaneous *	23.26

Source: Economic Survey 2005-06

*Medical care, education, transports & communications, recreation & amusement personal care & effects, laundry, domestic services etc.

Authority for compilation & Release: Labour Bureau, Shimla, Ministry of Labour.

Use: Used for wage indexation in government and organized sector.

CPI for Urban Non-Manual Employees (CPI – UNME)

This index measures the change in the price of commodity basket consumed by the non manual employees like office goers. CPI-UNME earlier compiled by the Central Statistical Organisation as an independent index has since been discontinued and is currently linked to the CPI-IW.[6]

Uses

Basically used for determining dearness allowances of employee of some foreign companies working in India in service sectors such as Airlines, Communications, Banking, Insurance & other financial services.

Used under the Income Tax Act to determine capital gains.

Used by Central Statistical Organisation (CSO) for deflating selected service sectors' contribution to GDP at factor cost at current prices to get the corresponding figures at constant prices.

Authority for compilation & Release: CSO – Central Statistical Organisation, Ministry of Statistics and Programme Implementation.

6 Economic survey 2008-09, p. 67

CPI for Rural Labourers and Agricultural Labourers (CPI – AL)

Consumer Price Index for rural labourers measures the change in the price of commodity basket consumed by rural labourers like agriculture labourers, labourers of village and cottage industries etc.

Consumer Price Index for Agricultural Labourers (CPI – AL) is a subset of Consumer Price Index for Rural Labourers (CPI-RL). It is basically used for revising minimum wages for agricultural labourers in different states.

Authority for compilation and release of both indices: Labour Bureau, Shimla, Ministry of Labour.

NEW CONSUMER PRICE INDICES

The above old consumer price indices cover only a segment of population like Agriculture Labour, Industrial worker etc., and do not give a nationwide picture. Therefore, three new indices are introduced with base year of 2010 (January – December) which cover all segments of population on all India basis. They are as follows:

1. CPI (Rural)
2. CPI (Urban)
3. CPI (Combined)

These indices are published for all India as well as state / union territory level. These indices are released with one month time

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lag. The CPI (Combined) is computed by combining Rural and Urban index. From January 2012, these new indices are released.

Table 9.4. Commodity groups and their weights for rural, urban and combined

SNo	Groups	Rural	Urban	Combined
1.	Food, beverages and tobacco	59.31	37.15	49.17
2.	Fuel & Light	10.42	8.40	9.49
3.	Clothing, Bedding & Foot wear	5.36	3.91	4.73
4.	Housing	-	22.53	9.77
5.	Miscella-neous	24.91	28.00	26.31
6.	Total	100	100	100

Source: Central Statistics Office, Ministry of Statistics and Programme Implementation, Government of India.

TYPES OF INFLATION

Different Inflations Based on Rate of Rise in Prices

1. Creeping Inflation

Price rise at very slow rate (less than 3%) like that of a snail or creeper is called Creeping inflation. It is regarded safe and essential for economic growth.

2. Walking or Trotting Inflation

Price rise moderately at the rate of 3 to 7% (or) less than 10% is called Walking or trotting inflation. It is a warning signal to the government to be prepared to control inflation. If the inflation crosses this range, it will have serious implication on the economy and individuals.

3. Running Inflation

Running inflation means price rise rapidly like the running of a horse at a rate of 10-20%. It affects the economy adversely.

4. Hyperinflation (or) Runaway (or) Galloping Inflation

The price rise at very fast at double or triple digit rate from 20 to 100% or more is called Hyperinflation (or) Runaway (or) galloping inflation. Such a situation brings total collapse of the monetary system because of the continuous fall in the purchasing power of money.

Different Inflations Based on Causes

1. Demand Pull Inflation

Demand pull inflation arises due to higher demand for goods and services over the available supply. Higher demand for goods and services arises due to increase in income of the people, increase in money supply and change in the taste and preference of people etc. In other words, demand pull inflation takes place when increase in production lags behind the increase in money supply.

2. Cost Push Inflation

Price rise due to increased input costs like raw material, wages, profit margin etc., is called Cost push inflation.

Both demand pull inflation and cost push inflation are affected by forces of demand and supply. They are discussed below.

Factors Affecting Demand

a. Increase in Money Supply

Increase in money supply leads to price rise. More money available with people induces people to purchase more goods and services. It means there is an increase in demand. So, prices move upward.

For example, consider a person who goes to market with more money and another one person with less money on a particular day. The former may buy more goods than latter. Likewise, if all people have more money, all may purchase more goods. It leads to price rise in the market.

b. Increase in Disposable Income

The increase in the disposable income leads to higher spending on the part of households. It hikes the level of price.

c. Cheap Monetary Policy

Cheap monetary policy means loan availability at very low interest rate and at easy terms. It leads to more investment by investors with loaned money. It pushes up the demand for capital goods and rise in price of the same.

d. Increase in Public Expenditure

Increase in government expenditure over its income, leads to deficit budget. Increase in government spending increases the demand for consumption and capital goods and services. It increases the price of both goods and services.

e. Repayment of Public Debt

The repayment of public debt borrowed by government to public leaves people with more money. It induces people to spend more. It ultimately leads to increase in price of goods and services.

Factors Affecting Supply

a. Shortage of Factors of production

The shortage in the factors of production viz., land, labour, and capital increases the cost of production. For example, shortage in the labour leads to higher wages. It increases the cost of production and price of goods and services.

b. Industrial Disputes

Industrial disputes lead to strike or lay off. It affects the production and supply of goods. It results in increased prices.

c. Natural Calamities

Natural calamities like earth quake, land slide and tsunami, affect production and supply of goods and services. The end result is price rise.

d. Artificial Scarcities

Artificial scarcities created by activities like hoarding and speculative trading in commodities in the commodities future market, results in price hike.

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e. Increase in Exports

Increase in export of a particular commodity leads to shortage of goods in the domestic market. It pushes up prices.

f. International Factors

International factors like oil price hike, shortage in production of certain commodities leads to higher import prices.

EFFECTS OF INFLATION

Inflation has impact on all the economic units. It has favourable impact on some and unfavourable impact on others. The effects are discussed under three different heads as under:

1. Redistribution of income and wealth

It redistributes income from one hand to another. It leads to loss to some group of people and gain to another group of people.

a. Debtors Vs Creditors

In case of debtor and creditor, debtor is gainer and creditor is loser. Take an example. The debtor borrowed ₹ 100 for interest at the rate of 5 % a day and debtor is a mango vendor. He has to repay Rs 105 on the next day. The price of mango on day one is ₹10 per mango. The debtor can buy 10 mangoes. On day two, the price of mango is ₹15. The debtor can sell 10 mangoes for ₹ 150. The debtor can repay his debt by selling only 7 mangoes. So he gains ₹ 45 or 3 mangoes. The creditor can buy only 7 mangoes with ₹ 105 he got back. Suppose, he purchased mango on day one instead of lending, he may have bought 10 mangoes. So he loses 3 mangoes.This relation holds true for private as well as public debt.

b. Producers Vs Consumers

In inflationary situation, the producers stand to gain and consumers stand to lose. The producer's profit will increase as a result of inflation. The purchasing power of money held by consumer falls. So, they have to pay more money to purchase the same amount of goods and services what they bought before inflation. Here, the income of consumer gets transferred from consumers to producers.

c. Flexible income group Vs Fixed income group

The flexible income groups like sellers, self employed, and employees of private concerns whose salary is adjusted according to inflation do not get affected, but fixed income groups like daily wage earners lose as the purchasing power of their income diminishes.

d. Debentures or Bond holders and Savers Vs Equity holders

The Debentures or Bond holders and Savers receive fixed periodical income from their financial assets. The purchasing power of their asset remains intact only if interest rate is more than rate of inflation. Take an example where the interest rate is 8%.The investor can earn ₹ 8 for ₹ 100 investment. Suppose, if the rate of inflation is 10% she/he can buy fewer goods than that of her/his purchase before inflation with the invested amount.

The bond issuers gain, the bond holders lose. The fixed interest rate paid for the bonds are not enough to compensate the effect of inflation. So to avoid this, interest is fixed on the basis of inflation. It means interest vary according to inflation. If inflation is 10 % the interest rate shall be adequate to compensate this 10%. The interest rate may be 10 % or more. These types of bonds are called **Inflation indexed bonds**.

The security holders' income depends on the profit of the company. In inflationary situation, the companies earn more profit. So, the equity holders also earn more income.

2. Effects on Production and Consumption

The inflation may lead to fall in the demand for goods and services. It may curtail the amount of production. Inflation also leads to reallocation of resources. Sometimes, only few goods may experience price rise. In that case, the investment from other sectors may shift to these sectors.

In packaged items, in order to maintain same price per package, the producers reduce the quantity or quality or both instead of raising price. It means, less production and consumption.

3. Other Effects

a) Balance of Payment (BoP)

High price reduces the amount of export and increases import from other countries where goods are available at cheaper rate. It results in unfavourable balance of payment.

b) Exchange Rate

High import and low export means high demand for foreign currencies compared to domestic currency. This depreciates domestic currency.

c) Social and Political

Higher rate of inflation leads to social and political tension. The political parties and organised group of people call for strike, hartals and stage dharnas.

MEASURES TO CONTROL INFLATION

The control of inflation needs a multi-pronged strategy. All the strategies need cooperation and harmony among them.

1. Monetary Measures

a. Credit Control

Credit control method is used by RBI to control inflation. It is discussed in detail in the chapter 5 named Indian Financial System- Money Market. RBI used Wholesale Price Index based inflation as a bench mark to control inflation. But now based on Urjit Patel Committee

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recommendation, RBI shifted targeting to newly introduced CPI (Combined). The reason is that the CPI (combined) measures the inflation in the consumer market. So it reflects the true and correct cost of living compared to WPI. The people expectation about future inflation is also based on price level in the consumer market.

b. Demonetisation of Currency

Demonetisation of currency means declaring that hereafter currencies of particular denominations are invalid. It suddenly reduces the money to the extent of money kept in those particular denominations. It is resorted to only in extreme cases.

c. Issue of New Currency

In this case all the money in circulation is withdrawn by government and new currency is issued. The new currency of single unit will be made equal to many units of old currency. For example new currency of one Rupee will be made equal to ₹ 100 of old currency. So the money supply is reduced to 1/100th. This too is resorted only under extreme cases.

2. Fiscal Measures

a. Reduction in unnecessary Expenditure

Reduction of unnecessary government expenditure means less demand from government side. It brings down the price level.

b. Increase in Direct Taxes

Increase in direct taxes like income tax reduces the disposable income available with people. It means low demand from households. Less demand leads to lower price.

c. Decrease in Indirect Taxes

Decrease in indirect taxes like excise duty, sales tax brings the prices down.

d. Surplus Budget

Surplus budget means less expenditure than receipts. It reduces the money supply and government demand for goods and services. The price level is brought down due to this.

3. Trade measures

Trade measures refer to export and import of goods and services. In case of shortage of goods in domestic market, the supply can be increased through import of goods from foreign countries at low or nil import duty. The restriction in the form of import licenses has to be eased to increase import. The higher supply helps to bring down the price.

4. Administrative Measures

a. Rational Wage Policy

Rational wage policy helps to keep the cost of production under control. The cost control means price control.

b. Price Control

Direct price control also helps in

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inflation control. Price can be controlled by fixing maximum price limits through administered price system and subsidy from the government.

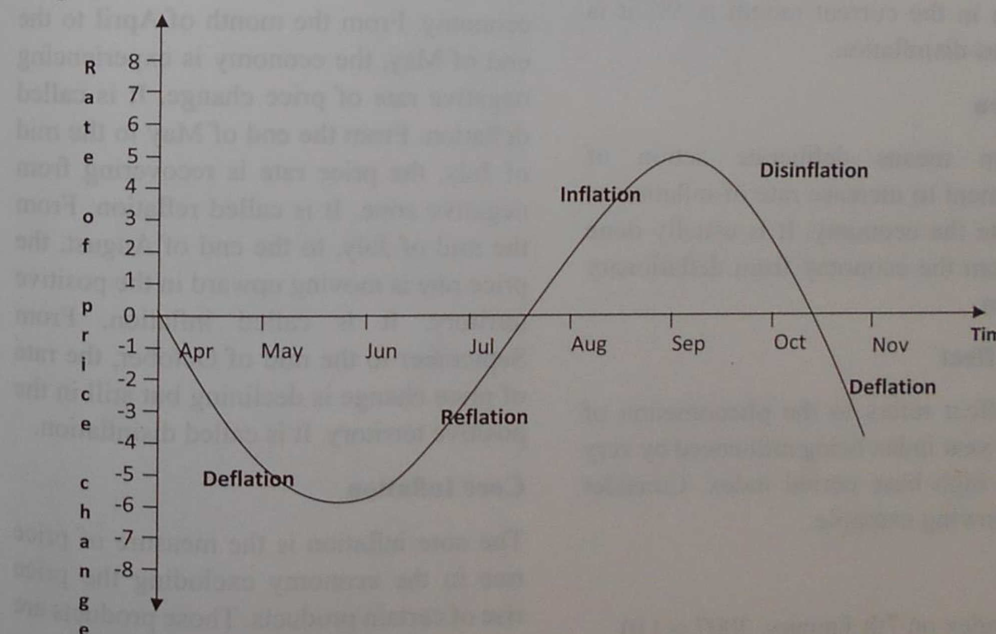
c. Rationing

Rationing of goods in short supply keeps the demand under control so that price comes under control.

Deflation

Deflation is opposite to that of inflation. The persistent and appreciable fall in the general level of prices is called as deflation. The rate of change of price index is negative. The effects, causes and measures are also in the opposite direction.

Fig 9.3

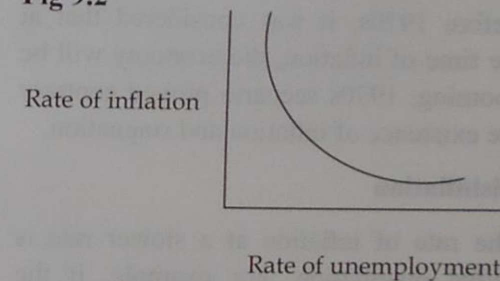


RELATED TERMS

Philips Curve

Philips curve shows the relationship between rate of inflation and rate of unemployment. It shows that the relationship is negative. That is at high rate of inflation the unemployment rate is low as show in fig. 9.2 below.

Fig 9.2



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Stagflation

Stagflation refers to the situation of coexistence of stagnation and inflation in the economy. Stagnation means low National Income growth and high unemployment. The Philips curve shows that at high rate of inflation, there is low rate of unemployment. But stagflation proves the contrary.

Before 1970s, it was considered that at the time of inflation, the economy will be booming. 1970s scenario proved contrary the existence of inflation and stagnation.

Disinflation

The rate of inflation at a slower rate is called disinflation. For example, if the inflation of last month was 6% and rate of inflation in the current month is 5% it is termed as disinflation.

Reflation

Reflation means deliberate action of government to increase rate of inflation to stimulate the economy. It is usually done to redeem the economy from deflationary situation.

Base Effect

Base effect refers to the phenomenon of current year index being influenced by very low or high base period index. Consider the following example.

Case 1

Price index on 7th January, 2007 = 110

Price index on 7th January, 2008 = 120

Rate of inflation on 7th January, 2008 = 120 - 110/110 * 100 = 9.09 %

Case 2

Price index on 10th March, 2008 =180

Price index on 10th March, 2009 =190

Rate of inflation on 10th March, 2009 = 190 - 180/180 * 100 = 5.55%

In both the cases, the index number increased by 10, but the rate of inflation is different. The rate of inflation is low in second case compared to first case. This is because of the difference in base period index.

A Comprehensive Picture

The figure 9.3 in the previous page depicts the various rates of price changes in the economy. From the month of April to the end of May, the economy is experiencing negative rate of price change. It is called deflation. From the end of May to the mid of July, the price rate is recovering from negative zone. It is called reflation. From the mid of July, to the end of August, the price rate is moving upward in the positive territory. It is called inflation. From September to the mid of October, the rate of price change is declining but still in the positive territory. It is called disinflation.

Core Inflation

The core inflation is the measure of price rice in the economy excluding the price rise of certain products. Those products are whose price is very volatile and temporary in nature. Example for these products is fruits and vegetable. These products are seasonal. During the season they are available in plenty and prices are low but in offseason these are scarce and prices are high. It means its prices are temporary and volatile. It is measured to study the long term trend in the price rise. So that the long term policies can be framed to control inflation.

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Price index on 10th March, 2009 = 190

Rate of inflation on 10th March, 2009 is 190 - 180/180 * 100 = 5.55%

In both the cases, the index number increased by 10, but the rate of inflation is different. The rate of inflation is low in second case compared to first case. This is because of the difference in base period index.

A Comprehensive Picture

The figure 9.3 in the previous page depicts the various rates of price changes in the economy. From the month of April to the end of May, the economy is experiencing negative rate of price change. It is called deflation. From the end of May to the mid of July, the price rate is recovering from negative zone. It is called reflation. From the end of July, to the end of August, the inflation is moving upward in the positive territory. It is called inflation. From September to the mid of October, the rate of price change is declining but still in the positive territory. It is called disinflation.

Core Inflation

The core inflation is the measure of price rise in the economy excluding the price rise in certain products. These products are [illegible] volatile and temporary.

CHAPTER 10

EXTERNAL TRADE AND CAPITAL

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CHAPTER 10

EXTERNAL TRADE AND CAPITAL

In this Chapter, I will learn

- BALANCE OF PAYMENT
- FOREIGN EXCHANGE
- PURCHASING POWER PARITY (PPP)
- CONVERTIBILITY
- BARRIERS TO TRADE
- ECONOMIC INTEGRATION
- RELATED TERMS

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External sector deals with export and import of goods and services, and financial capital between nations. The countries export goods and services over which it has advantage over other countries and import goods and services in which it lacks advantage over others.

This chapter covers balance of payment, foreign exchange, purchasing power parity, convertibility, barriers to trade, economic integration and related terms.

BALANCE OF PAYMENT[1]

The balance of payment of a country is a systematic record of all its economic transactions with the outside world in a given year.[2] The term 'all transaction' means transaction of government as well as private. It is a double entry book keeping. Double entry book keeping means recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow). For example while importing the goods the good imported inflows. It is credited as 'import'. At the same time equivalent amount of money needs to be paid. It is debited as 'payable' in the name of the person from whom the import was made.

It means the incomings are credited and outgoings are debited.

The balance of payment is explained in detail with the help of the table 10.1.

I. Current Account

The external transactions are classified as current account and capital account transactions. This classification is similar to to the classification of receipts and expenditure as revenue receipts and capital receipts and revenue expenditure and capital expenditure in public finance. Current account transactions are like revenue receipts and revenue expenditures and capital account transactions are like capital receipts and capital expenditures.

Current account transactions are single time and one way transactions. It means the transaction either receipt or payment happens once and the transaction ends there. For example if a person exports goods he gives the goods and receives money and the transaction comes to an end with respect to the particular good exported.

1. Export

Export means the receipts against export of merchandise goods to other countries. The export receipts of services are not included here.

2. Import

Import means the payment for import of merchandise goods from other countries. The payments for import of services are not included here.

1 The contents of this part is heavily drawn from Balance of Payments Manual for India, September 2010, RBI

2 M.L. Jhingan International Economics

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3. Trade balance

The balance of trade is difference between export receipts and import payments.

Trade balance = Export - Import

4. Invisibles (net)[3]

The head of invisibles record the receipts and payments regarding services exports and imports and other current account payments viz.,

A. Non-factor services

B. Income and

C. Private Transfers.

A. Non-Factor Services

Non-factor services refer to all invisible receipts or payments not attributable to conventional factor of production, i.e labour (remittances from overseas migrants). Thus Non-factor services mean the export and import of services alone. The non-factor services includes Group of Services viz., Travel, Transportation, Insurance, Government Not Included Elsewhere (GNIE) and Miscellaneous Services, which encompass communication services, construction services, financial services, software services, news agency services, royalties, management services and business services etc. The software services comprise information technology (IT) and IT-enabled services (ITES).

3 Net means the difference between inward flow and outward flow.

B. Income

Income includes transactions regarding income from investments in the form of dividends, profit and interest from loans, rent from house property and income generated through employment.

Remittance is directly earned by labour which is a factor of production and incomes like dividend, profit and interest are earned by capital which is also a factor of production. So the income from both these heads is called factor income services.

C. Private Transfers

Private transfers include grants, gifts, etc., which do not have any quid pro quo. Without any quid pro quo means it need not be compensated. Once it is received it need not be repaid.

Current account balance

Current account balance is the sum of the items 3 and 4 viz, trade balance and net invisibles.

Current account balance = Trade balance + Net invisibles.

If the current account balance is positive, it is said to be surplus which means favourable current account balance. If the current account balance is negative, it is said to be deficit which means unfavourable current account balance.

II. Capital Account

Capital account transactions are two way and multiple transactions. It means paid

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money can be recovered through periodical income and/or by disposal of the asset created. Likewise the received money needs to be repaid periodically and settled finally by repaying the full amount. For example from the loan paid to a foreigner periodical interest income can be received at the same time the paid principal amount can be recovered from the debtor.

i. External assistance (net)

External assistance means the transaction of official (government) bilateral and multilateral loans. The bilateral loans are loan transactions between two countries. Multilateral loans are official loan transactions between a country and multilateral bodies like World Bank, IMF and Asian Development Bank etc.

ii. External Commercial Borrowings (net)

Commercial borrowing means loan transaction by commercial enterprises. It is also called as External Commercial Borrowing (ECB).

ECB refer to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments availed of from non-resident lenders with a minimum average maturity of 3 years.

Securitised instruments refer to debt securities like bonds and preference shares. Buyers' credit and suppliers' credit are called trade credits. Depending on the source of finance, such trade credits are classified as Suppliers' Credit or Buyers' Credit. Suppliers' credit relates to credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for repayment of imports into India arranged by the importer from a bank or financial institution outside India. It is to be noted that both of them are for the purpose of import and loan availed by importer. In the Supplier's credit only two parties namely exporter and importer are involved in the buyer's credit a third party namely bank or financial institution comes into the picture to finance the import.

ECB can be raised only for specific purposes, such as the import of capital goods, implementation of new projects etc; this restriction is called end use restriction.

The heading External Commercial Borrowings also covers Foreign Currency Convertible Bonds (FCCB) and Foreign Currency Exchangeable Bonds.

FCCB are bonds issued by an Indian company expressed in foreign currency. The principal and interest in respect of these bonds are payable in foreign currency.

A Foreign Currency Exchangeable Bond (FCEB) means a bond expressed in foreign currency issued by an issuing company. These are issued to persons who are residents outside India. These are exchangeable into equity share of another company, called the Offered Company. The principal and interest in respect of these bonds are payable in foreign currency. The word 'Exchangeable' refers to the facility to convert bond of one company into equity share of another company.

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iii. Short-term debt

Short-term debts are trade credits for a maturity of less than three years.

iv. Banking Capital

Banking capital comprises three components:

(a) Foreign assets of commercial banks

(b) Foreign liabilities of commercial banks and

(c) Others

"Foreign assets" of commercial banks consist of

(i) foreign currency holdings, and

(ii) rupee overdrafts to non-resident banks.

"Foreign liabilities" of commercial banks consist of

(i) non-resident deposits and

(ii) liabilities other than non-resident deposits, which comprise rupee and foreign currency liabilities to non-resident banks and official and semi-official institutions.

"Others" under banking capital include transaction in balances of foreign central banks and international institutions like the IBRD, IDA, ADB, IFC, IFAD, etc., maintained with the Deposit Accounts Department (DAD) of the RBI as well as transaction in balances held abroad by the Embassies of India in London and Tokyo.

Non- resident deposits

The deposit received from non resident Indians come under this head. At present, there are three, types of NRI Deposit Schemes. They are:

Foreign Currency Non-Resident (Banks) - FCNR(B)

Non Resident External Rupee Accounts NR(E)RA

Non Resident Ordinary Rupee Account (NRO)

Foreign Currency Non-Resident (Banks) - FCNR(B)

These deposits are held in the following foreign currencies, US $, Pound Sterling, Euro, Japanese Yen, Australian $ and Canadian $. Only term deposits of one to three years maturity is allowed. The interest rates are pegged to LIBOR[4]/SWAP[5] of corresponding maturities.

4 LIBOR stands for London Interbank offer rate. It means the interest rate in the London call money market.

5 Swap is a common arrangement for exchanging one with another in financial market instruments like debt, share etc. Exchange can be between shares, between debentures etc,. Here SWAP is the exchange of loan in one currency to loan another currency. The interest rate difference between these loans is called SWAP rate, generally as SWAP. http://www.swap-rates.com/Definitions.html observes as, "Swap is a debit or credit paid or earned as a reflection of the varying interest rates applicable to currency pairs. When trading the USD for example, swap rates will be determined based on the interest rates of the countries being represented by this pair. Depending on whether you are long or short and which country has higher interest rates, you may be charged or credited interest. Essentially, when a trader holds a position over night they are subject to the interest rates applicable to the currency pair they are trading. 'Swap' is also commonly referred to as 'rollover rates'."

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Non-Resident External Rupee Account NR(E)RA

These deposits are held in Indian Rupee. Term deposits with maturity of one to three years as well as saving deposits are allowed under this scheme. Its interest rate is also pegged to LIBOR/SWAP rate.

Non-Resident Ordinary Rupee Account (NRO)

It is the account held by Indians ordinarily living abroad. An Indian who was Indian resident but migrated abroad can shift his account to this category. It is held in Indian Rupee. NRO accounts can be opened as current, savings, recurring or fixed deposit accounts.

v. Foreign Investments

There are two types of foreign investments. One is foreign direct investment and another is portfolio investment. Portfolio investment is also called as rentier investment.

A. Foreign Direct Investment (FDI)

Investment through the mode other than the stock exchange is called foreign direct investment in India. There is prescribed size to treat an investment as foreign direct investment. FDI includes the following:

- Shares acquired by way of IPO
- Shares acquired by way of preferential allotment
- Shares acquired by way of offer for sale through private arrangement
- Transfer of shares by way of offer for sale through private arrangement

In all these purchases there is direct contact between the securities buyer and the seller company.

Aravind Mayaram Committee on FDI and FII has suggested that the investment in a company above 10 % needs to be treated as FDI.

Table 10.1 Balance of Payment

Sl. No.	Item	2009-10	2010-11
I	Current account		
1	Exports	182442	256159
2	Imports	300644	383481
3	Trade balance	-118202	-127322
4	Invisibles (Net)	80022	79269
	A. Services	36016	44081
	B. Transfer	52045	53140
	C. Income	-8038	-17952
	Current account balance	-38180	-48053
II	Capital account		
i.	External assistance	2890	4941
ii.	External commercial borrowings	2000	12160
iii.	Short-term debt	7558	12034
iv.	Banking capital of which	2083	4962
	Non-resident deposits	2922	3238
v.	Foreign investment	50362	42127
	A. FDI	17966	11834
	B. Portfolio investment	32396	30293
vi.	Other flows	-13259	-12484
	Capital account balance	51634	63740
	Capital account (including errors & omissions)	51622	61104
III	Errors & omissions	-12	-2636
IV	Overall balance	13441	13050
V	Reserves change (-indicates increase, +indicates decrease)	-13441	-13050

Source : Reserve Bank of India (RBI)

Notes : PR: partially revised, P: preliminary

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B. Portfolio (or) Rentier Investment

Investment through stock exchange that is through secondary market is called port folio investment. Portfolio investment refers to investment in various financial instruments like shares, debentures of a company through secondary market. There are three major types of portfolio investment. They are:

- Foreign Institutional Investment (FII)
- Depository Receipts
- Offshore Funds

Foreign Institutional Investment

It is the portfolio investment by foreign institutions like Mutual funds, Insurance Cos, Pension funds etc., in shares and debentures.

Depository Receipts

Companies of a country can go abroad to sell their shares in foreign capital market. When a foreign investor buys shares of domestic companies abroad (in capital market), he is issued a receipt by a custodian Bank. This receipt represents a certain number of underlying shares of domestic companies and hence they are called Depository receipts.

The depository receipts raised by Indian companies in American market are called American Depository Receipts (ADRs) and those that are raised in some other countries are called Global Depository Receipts (GDR). The depository receipts raised by foreign companies in Indian market are called Indian Depository Receipts (IDRs).

Offshore Funds

These are money raised from offshore destination (low tax or no tax countries) like Cayman Islands, Isle Of Man, Mauritius and British Virgin Islands etc., by mutual funds and other investment funds.

vi. Other Flows

Other flows include, delayed export receipts, leads and lags in export receipts (the difference between the customs data and the banking channel data), funds held abroad, and other capital transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, and sale of intangible assets such as patents, copyrights, trademarks etc.,.

The difference between the customs data and the banking channel data arises because banking channels data relies on foreign exchange release/receipt returns which are actual cash outgo and cover all flow and customs data are based on bills of entries (import document filed with the customs), which might remain somewhat incomplete for a number of reasons in the short run. Defense imports are not reflected in the customs data.

Capital Account Balance

It is the sum of items i to vi above.

Capital account total (net) = External assistance (net) + Commercial Borrowings (net) + Nonresident deposits (net) + Foreign investments (net) + Other flows (net).

If the capital account balance is positive, it is said to be surplus. Surplus capital account balance means favourable capital account balance. If the capital account balance is negative, it is said to be deficit. Deficit capital account balance means unfavourable capital account balance.

IV. Overall balance

The overall balance is the sum of current account balance and capital account balance.

Overall balance = Current account balance + Capital account balance

If there is a positive balance it increases the reserve and vice-versa.

Capital account balance is calculated with and without errors and omission. Errors and omission means the difference between debit and credit entries of all transaction. Already it was said that each transaction is entered twice in double entry book keeping by recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow).

Ideally speaking in this system both debit side and credit side should be equal but as the data is compiled from various sources some mismatch if found to happen. This is called errors and omission.

V. Reserves

Reserve means foreign exchange reserve. The sum of current and capital account balance is the balance of payment.

Balance of payment = current account balance + capital account balance

The balance is added to foreign exchange reserve if the balance of payment is in surplus. The balance is deducted if the balance of payment is in deficit. It means payment is made out of old balance (foreign exchange reserve).

The foreign exchange reserve consists of

Foreign Currency Assets

Gold Stock of RBI

SDR (Special Drawing Right) holdings of the government

Reserve Tranche

Foreign Currency Assets

Currencies of various countries are held in foreign exchange reserve. It is expressed in US $ or Indian Rupee terms after converting currencies of various countries by their respective exchange rate against US $ or Indian Rupee respectively. Apart from currency it also includes foreign currency deposits held by RBI with foreign central banks, the BIS and non-resident deposit taking institutions as well as deposit agreements with IMF Trust Accounts that are readily available to meet a BoP financing need. The securities issued by non-residents and financial derivatives

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having underlying foreign currency assets also form part of foreign currency assets.

Gold Stock of RBI

The RBI has gold stock as a back up to issue currency and to meet unexpected Balance of Payment problem. Its value is expressed in terms of US$ or Indian Rupee.

SDR Holdings

SDR is a reserve created by International Monetary Fund (IMF) to help countries that have Balance of Payment problem. The member countries have to contribute to this account. The contribution is in proportion of their IMF quota (membership fee). It is held with the government or the Central bank of the member countries. In India, it is with RBI's exchange reserve. The detailed explanation of SDR is followed by next topic namely Reserve Tranche.

Reserve Tranche

Tranche means portion or slice. Reserve tranche means a portion of fund. It consists of India's quota (member subscription fee) to IMF and lending to General Resource Account of IMF. General Resource Account is the pool of member counties' quota payment. A member is required to pay 25 per cent of its quota in SDRs or in foreign currencies acceptable to the IMF (i.e., hard currencies). This is termed "reserve position in the IMF or reserve tranche" and is part of the member country's reserve assets. If any money was lent in foreign currency or SDR over and above the quota to IMF's General Resource Account it also form part of reserve tarnche.

SDR

SDR has two dimensions. One, it is an exchange rate system and another it is a loan arrangement.

As an exchange rate system, the SDR is an average exchange rate derived from a basket of four currencies viz, US $, Euro, UK Sterling Pound and Japanese Yen. In this system, these four currencies are assigned different weightage as per their importance in world economy and an exchange rate is derived which is called as SDR. The exchange rate of a country is expressed against SDR. For example; ` 30 = 1 SDR. You may see quota of India in IMF as SDR 4158.2 million (or something else if altered). Here India's quota is expressed in SDR, in place of Indian Rupee or US $.

As a loan arrangement, the member countries are entitled to get loan from IMF's Special Drawing Account. This loan amount is up to 200% of the member's Quota with IMF. It is also known as paper gold. In this arrangement IMF does not lend directly. It is the member countries who are in strong position lend their SDR holdings to member countries who are in Balance of Payment problem.

FOREIGN EXCHANGE

Exchange Rate

It is the rate at which home currency is exchanged for one unit of foreign currency.

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For example ₹ 50 = US $1. M.L. Jhingan defines exchange rate as follow. "The foreign exchange rate or exchange rate is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency". The exchange rate varies (either depreciates or appreciates) depending upon the demand for and supply of currencies.

Depreciation

Increase in the exchange rate i.e. fall in the external value of domestic currency because of more demand for foreign currency (less supply of foreign currency) or more supply of (less Demand of) Domestic currency is called depreciation.

For example,

On day one the exchange rate is ₹ 50 = US $1

On day two the exchange rate is ₹ 52 = US $1.

It refers to Rupee depreciation.

Appreciation

Fall in the exchange rate i.e increase in the external value of domestic currency, due to more demand for home currency (or less supply of home currency) or less demand for (or more supply of) foreign currency is called Appreciation.

For example,

On day one the exchange rate is ₹ 50 = US $1

On day two the exchange rate is ₹ 48 = US $1.

It refers to Rupee appreciation.

Devaluation

Reduction in the external value of home currency is called Devaluation. For example changing the exchange rate from ₹ 50 = US $1 to ₹ 75 = US $1 is called devaluation. Devaluation is aimed at increasing export of the country. It is usually resorted to correct the deficit in the balance of payment.

How Export Increases

Both depreciation and devaluation helps to increase export. This can be clearly illustrated from the following example.

Consider price of rice per kg is ₹ 25. And consider that a foreigner wants to import rice from India. When the exchange rate is ₹ 50 = US $1 with US $1 foreigner can import 2 kg of rice.

After devaluation i.e. ₹ 75 = US $1 with $1 foreigner can import 3 kg. It means rice is available at a cheaper rate so he will buy more rice. So export increases. The reverse happens to import and hence the import will decrease. Devaluation also increases the profit of the exporter.

For example consider that a rice exporter earns ₹ 1 per kg as profit, before devaluation he earns ₹ 2 by exporting two kg and earn ₹ 3 after devaluation by exporting three kg. Opposite is the case with appreciation and revaluation.

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Revaluation

Increase in the external value of currency is called Revaluation. For example changing the exchange rate from ₹ 50 = $1 to ₹ 25 = US $1 is called revaluation. Revaluation is aimed at decreasing export of the country. It is usually resorted to correct the surplus in the balance of payment. Surplus in the balance of payment of home country mean deficit for some other countries. To correct it revaluation is carried out. It is very rarely done.

Note: While depreciation and appreciation takes place automatically due to movement in the demand and supply of currencies in the market, devaluation and revaluation are done voluntarily either by the government or monetary authority.

PURCHASING POWER PARITY (PPP)

PPP, proposed by Gustav Cassel, is a method of determining exchange rate. Purchasing Power Parity means the equality of buying capacity. Based on the buying capacity (purchasing power) of respective currencies in their home country the exchange rate is determined.

For example if with ₹ 25 a bundle of goods can be purchased in India, which can be purchased by $1 in US then exchange rate is ₹ 25 = US $1.

Converting Prevailing (BOP based) Exchange Rate into PPP

PPP exchange rate can be calculated from the prevailing exchange rate using price index of two countries.

PPP exchange rate = Domestic price index/ Foreign Price index X Prevailing market exchange rate

= 25/50 X 50 = 25

Need for PPP

It is customary to compare level of development of different countries based on living standard of people. The standard of living is measured by proxy variable, namely per capita income. People in countries with high per capita income are considered to be enjoying high standard of living and such countries are considered developed countries. Later it was realized that standard of living is not in the amount of money they have but the amount of goods they can have with that money i. e. purchasing power of money.

To compare the income of the two countries, it is necessary to convert the income in different currencies into a single common currency. As of now, the common currency is US $. The conversion is done with the help of trade based prevailing exchange rate. The trade based exchange rate does not reflect the true purchasing power of different currencies because all the goods needed are not traded. So, the trade based exchange rate fails to reflect the purchasing power of money to buy non-traded goods. Apart from that, the trade is not a free flowing one. It is subject to many manipulations and obstructions and so is the exchange rate. To overcome this problem, the PPP based exchange rate is used to convert the income of different currencies in to a common currency, namely US PPP$.

Apart from the above cited reasons, it is important to note that the price of goods and services in developed countries is very high compared to developing and less developed countries. It is like the difference in price of goods and services between urban and rural areas. It means, the purchasing power of money in developed countries is lower than that of developing and less developed countries. So, in developing and less developed countries, less money is enough to buy more goods than that is possible in developed countries. So, with less money they enjoy high standard of living.

The trade based exchange rate does not reflect this reality. So, the PPP based exchange rate is used to compare the standard of living of people and stage of development.

Take an example;

The per capita income of India in Indian ` is 400. The same in US dollar is $8 when trade based exchange rate is ` 50 = $1. The same in PPP based exchange rate is $16, if PPP based exchange rate is ` 25 = PPP US $1.

It is vivid that the PPP based exchange rate reflects higher standard of living than trade based exchange rate system.

It is important to note that the PPP$ is a unit of account and not a medium of exchange. It means the PPP$ can be used for measurement of income and cannot be used to purchase or sale of goods.

CONVERTIBILITY

As said in the previous passages, exchange rate is not free market determined. It is subject to some restrictions like trade. Removing these restriction leads to convertibility.

Facility of exchanging domestic currency for foreign currency at market determined exchange rate without restriction on either rate or quantum of money exchanged is called convertibility.

The committee on fuller capital account convertibility observes as, "Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and vice versa. Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of payments and transfers for current international transactions, capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows."

Convertibility in India

The convertibility in India is a gradual one. Like other reforms it was also introduced in 1990s.Convertibility in current account was introduced first and then it was introduced in the capital account.

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Current Account Convertibility

Current account convertibility refers to the freedom of converting home currency into foreign currency with respect to transactions in current account.

Budget 1992 – 93 introduced Liberalized Exchange Rate Management System (LERMS). In this system, 60% of foreign exchange earnings are convertible at open market rate, and remaining 40% at RBI fixed rate.

In 1993 – 94, government introduced full convertibility in Trade account.

In 1994 – 95 budget, full convertibility in current account was introduced. But this was not satisfactory to the IMF. So government introduced further relaxations in August 1994. India got affiliation to the Article VIII of IMF.

Capital Account Convertibility

Capital account convertibility means the freedom to convert home currency into foreign currency regarding transactions in capital account.

The committee on fuller capital account convertibility observed as follows: "For the purpose of this Committee, the working definition of CAC would be as follows: CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments."

Fuller Capital account convertibility does not mean 100% freedom. There will be some restrictions. That is why committee on fuller capital account convertibility observed as above.

To bring capital account convertibility, the Government of India formed Capital Account Convertibility Committee – 1 (1996) and Committee on Fuller Capital Account Convertibility II (2006).

Capital Account Convertibility Committee

This committee was formed under the chairmanship of S.S. Tarapore the then deputy governor of RBI. It gave green signal to introduce Capital Account Convertibility. It recommended the introduction of CAC in a phased manner throughout the period of 1997–2000.

Government accepted it but, the East Asian crisis halted its implementation.

Committee on Fuller Capital Account Convertibility II

After a decade, another committee was formed, again under the chairmanship of S.S. Tarapore in 2006. This time also, its approach was the same.

It recommended capital account convertibility implementation in a phased manner, in 3 phases from 2006 to 2011.

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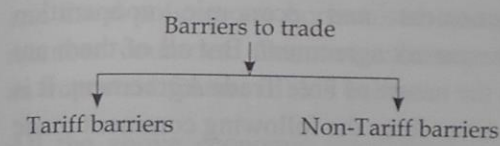
BARRIERS TO TRADE

The policy instruments which obstruct trade are called as barriers to trade. They are of two types namely tariff barriers and non-tariff barriers as shown in the following figure 10.1.

Fig 10.1



Tariff Barriers

Tariff means the duty on import and export of goods. M.L. Jhingan observes "But for practical purposes, a tariff is synonymous with import duties or custom duties".

The reason for imposing tariff on import and export is different. The tariff on import is to make the price of imported goods equal to domestic goods. It increases the price of imported goods. So import is discouraged. If it is imposed on export goods its aim is to discourage export and make the goods available in domestic market which otherwise may be exported. The common purpose for Tariff on import and export is to generate resource for government.

If tariff obstructs free flow of trade it is called tariff barrier.

Non-Tariff Barrier

The instruments and executive operations that obstruct free flow of trade other than tariff is called non tariff barriers. "Non-Tariff Barriers (NTBs) are obstacles to imports other than tariffs. They are administrative measures that are imposed by a domestic government to discriminate against foreign goods in favour of domestic goods." M.L Jhingan observes.

The major non tariff barriers are explained here.

a. Quota

It fixes a limit on the amount of trade that can take place. In this system only a fixed quantity is allowed to be exported to any country and imported from any country.

b. Production Subsidies

Production subsidies are given by government to producers of exportable goods for the production of goods and services. They are in the form of raw materials at low cost credit at low interest rates, and tax concessions etc...

c. Export subsidies

Export subsidies are given in the post production stage. They are in the form of transport subsidies and low cost shipment credits.

d. Health, sanitary & safety regulations

It refers to import restrictions on health and safety grounds. The countries that want to restrict import fix higher level of norms. The norms include for example the residue of pesticides in food products, level of germs etc.

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e. Packaging requirements

By fixing packaging requirements high restriction is imposed on trade. The standards push up the cost of product.So the import comes down. Some times the cost of pack exceeds the cost of product because of higher packaging requirement.

ECONOMIC INTEGRATION

Economic integration means the cooperation that exists between countries in the trade and other economic front such as investment, monetary policy etc. The level of integration varies between countries. On the basis of level of integration there are various names for it. Though it is difficult to differentiate them it is explained in the following passage.

Preferential Trade Agreement (PTA)

It is an agreement between two or more countries where the agreeing parties reduce the level of tariff imposed on traded goods among themselves. It is the first level of economic integration. The aim is to bring down the level of tariff and thereby increasing the flow of trade. The parties to the agreement maintain their own tariff level with third parties.

Free Trade Agreement / Area (FTA)

Free trade agreement/area is an improved level of economic integration compared to preferential trade agreement. In this arrangement the parties to the agreement abolish tariff on most of the goods and services and keep tariff on some items at a minimal level. Some goods which are identified as "sensitive goods" are continued to be traded at existing tariff level.

In recent times, the free trade agreement is called with different names. They are: comprehensive economic cooperation agreement, comprehensive partnership agreement and economic cooperation framework agreement. But all of them are in the nature of Free Trade Agreement. It is evident from the following comment made by Korea Joongang Daily on India Korea Comprehensive Economic Partnership Agreement: "The agreement, which got its unusual name at the request of the Indian side, is equivalent to a free trade agreement"[6] . But it cannot be refuted that there are some variations in all these agreements. These agreements cover foreign investment front apart from trade and services.

In this arrangement also, the parties to the agreement follow their own independent trade relation with third parties.

Customs Union (CU)

It is a still higher level of integration. In this, the member countries abolish barrier to trade and service among them, and as a whole, they maintain a common tariff against third parties.

6 India to sign deal next week July 31 2009, Joongang daily

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Common Market (CM)

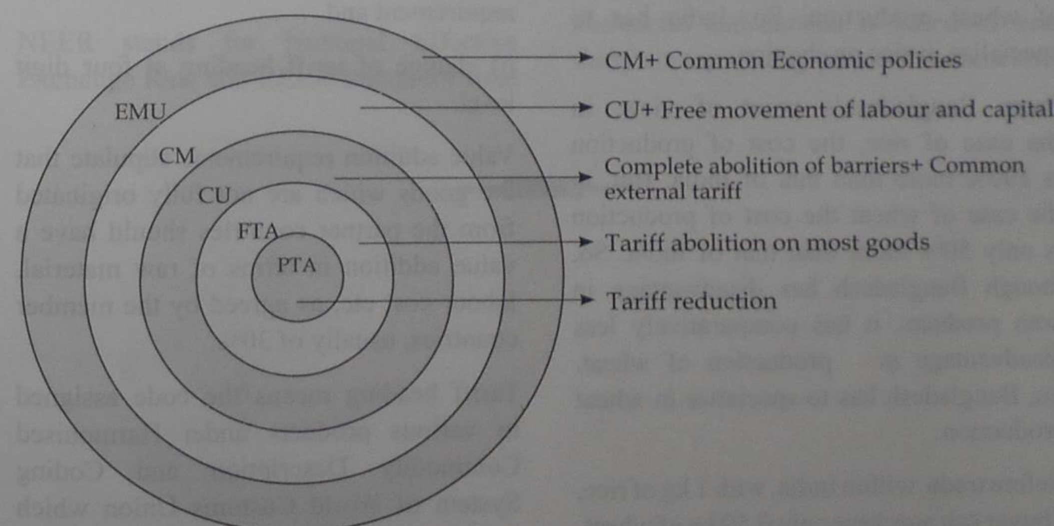
In addition to provisions of customs union, a free flow of labour and capital is also allowed in common market.

Economic and Monetary Union (EMU)

In this arrangement, in addition to common market's provision, the monetary and fiscal policies are hormonised among member countries. Common currency is an important feature of this union.

All the above economic integrations are illustrated in figure 10.2 below.

Fig 10.2



RELATED TERMS

Comparative Advantage

ComparativeAdvantage theory says that a country has to produce and export the goods in which it has comparative advantage. Let us see comparative advantage with an example.

The theory is explained with slight modification without affecting the essence of the theory. Assume that India and Bangladesh produce rice and wheat.

Assume that in India the cost of production

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of one kg rice is ₹ 25 and cost of production of wheat is ₹ 50. And in Bangladesh the cost of production of rice is ₹ 75 and of wheat is ₹ 100. It is tabulated in table 10.2.

Table 10.2 Cost of production

Produce	Cost of production in ₹	
	India	Bangladesh
Rice	25	75
Wheat	50	100

In both products, India has advantage compared to Bangladesh because both rice and wheat are cheaper in India. In case of rice, the cost of production in India is 50% of Bangladesh's cost of production. But in case of wheat, India's cost of production is 75% of Bangladesh's cost of production. It means, India has comparatively more advantage in rice production than that of wheat production. So, India has to specialise in rice production.

From Bangladesh's point of view, in the case of rice, the cost of production is 100% more than that of India. But, in the case of wheat the cost of production is only 50% more than that of India. So, though Bangladesh has disadvantage in both products, it has comparatively less disadvantage in production of wheat. So, Bangladesh has to specialise in wheat production.

Before trade, within India, with 1 kg of rice, a buyer can purchase only 0.50 kg of wheat. In Bangladesh, with 1 kg of rice, 0.75 kg of wheat can be purchased. Suppose, they enter into trade after specialistion and fix price at 1 kg of rice equal to 0.65 kg of wheat. By exporting 1 kg of rice, India can get 0.65 kg of wheat, i.e 0.15 kg more than what it would have got without trade. Bangladesh, with 0.65 kg of wheat, can get 1 kg of rice i.e., 0.1 kg less than what it would have offered without trade. So, trade benefits both.

Rule of Origin

It is a term used in all trade agreements. It is aimed at preventing third parties from routing their products through member countries to take advantage of low tariff and allowing only goods that are originated from parties to the agreement. Rule of origin is usually determined by two criteria namely,

i) value addition or local content requirement and

ii) change of tariff heading at four digit level.

Value addition requirements stipulate that the goods which are not fully originated from the partner countries should have a value addition in terms of raw material, labour cost etc, as agreed by the member countries, usually of 30%.

Tariff heading means the code assigned to various products under Harmonised Commodity Description and Coding System of World Customs Union which is called as Harmonised Coding System. The first four digits of the code are called Heading. The subsequent digits are called

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as sub heading. Change of tariff heading means, a product that does not originate from a country should be codified in different heading when exported, i.e., a product should be converted in to another product. For example, the code of live bovine animals is 0102. To be exported, it may be processed and converted as frozen meat of bovine animals, for which code is 0202.

Debt Service Ratio

The amount of a country's debt service (repayment of principal and interest) as a ratio of its total export earning is called Debt Service Ratio. It can be written in formulaic form as follows:

Debt service ratio = Debt service / Total export earning

NEER and REER

NEER stands for Nominal Effective Exchange Rate and REER stands for Real Effective Exchange Rate. Usually the exchange rate is determined for a domestic currency against a single foreign currency. In the effective exchange rate (EER) is fixed against a basket of currencies. For NEER and REER the basket is SDR currencies.

The way real GDP arrived from nominal GDP after correcting it for price change the REER is arrived from NEER.

NEER = Domestic currency exchange rate in terms of SDR/ Foreign Currency exchange rate in terms of SDR

REER = NEER X Domestic price index / Foreign price index

The price index is CPI (combined). The way it is calculated by the basket of SDR currencies there are two other EERs. One is based on top six trading partners' currencies and another is based on next thirty six top trading partners' currencies.

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CHAPTER 11

WORLD TRADE ORGANISATION (WTO)

[redacted] http://www.pdf4exams.com

In this Chapter, I will learn

- FROM GATT to WTO
- WTO'S PRINCIPLES
- STRUCTURE OF WTO
- AGREEMENTS
- WTO ROUNDS
- RELATED TERMS

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WTO is an international organization established to promote multilateral trade. It is successor to erstwhile GATT (General Agreement on Tariffs and Trade). It came into force on January 1, 1995 and has played a pivotal role in facilitating international trade.

This chapter covers formation of WTO, principles and structure of WTO and agreements of WTO.

FROM GATT to WTO

GATT is a forum for international trade. Actually it was intended to be established as an organization (International Trade Organisation) but US parliament refused to accede to it. So it came into force, as an agreement short of an institution, in 1947.

It was established with an aim to ensure free trade among world countries by way of reduction of tariff and other barriers to trade. Under the aegis of GATT, eight rounds of negotiations were held between 1986 and 94 among members to ensure free trade. The last one was Uruguay round.

The Uruguay round included the service trade, intellectual property rights, textiles and agriculture in its negotiation. As a result of conclusion of Uruguay Round (8th round) WTO has been established. This brought many amendments to GATT. This amended version now forms the basis for WTO.

PRINCIPLES OF WTO

The two main principles of WTO are Most Favoured Nation (MFN) and National Treatment (NT).

The principle of MFN calls the member countries to treat all nations on equal footing in the policies concerning import and export of goods and services. The principle of National Treatment calls to treat imported goods and services equal to domestic goods and services in domestic sale and consumption.

STRUCTURE OF WTO

Ministerial Conference, is the top level decision making body. It meets once in two years. The trade and commerce ministers, by whatever name called in member countries, form this council.

Next is the General Council. It is functioning under the Ministerial Conference. The ambassadors or other representatives appointed by member countries constitute this council. The general council also acts as **Dispute Settlement Body (DSB)** and **Trade Policy Review Body**. It meets many times in a year as and when required. As a DSB, it helps the member countries in solving their disputes arising out of trade. It also reviews the trade policies adopted by member countries to check if they are compatible with WTO's agreements and their impact on trade.

The Council for Trade in Goods is called Goods Council. It looks after the working of GATT agreement. The Council for Trade in Service is called Service Council. It looks after implementation of General

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Agreement on Trade in Services (GATS). TRIPS Council looks after issues related with Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement implementation. Apart from this there are many working committees and working groups that enable smooth functioning of WTO and its agreements.

AGREEMENTS

As a result of Uruguay round 20 agreements were signed. Here we are going to have a look about few important agreements - the WTO agreement, Agreement on Agriculture (AoA), Trade Related Aspects of Intellectual Property Rights (TRIPS), Trade Related Aspects of Investment Measures (TRIMS), General Agreement on Trade in Services (GATS)

WTO Agreement

The WTO was established under this agreement. It is an Umbrella agreement. Other agreements are annex to this agreement.

Agreement on Agriculture (AoA)

Agreement on Agriculture calls for freeing agriculture trade. The commitments under this agreement are based on **Special and Differential treatment**. Special and Differential treatment means flexible and lesser commitment on the part of developing and less developed countries compared to developed countries in fulfilling the obligation under this agreement. This agreement also has special safeguard mechanism. **Special safeguard mechanism** means the option available to countries to impose additional duties on imported products when there is surge in imports or products are imported at lower price. The main components of this agreement are Market access, Domestic support or Domestic subsidies and Export subsidies.

Market Access

Market access provision calls for provision of access to imported agricultural goods in the member countries. There are two provisions one is tariffication and tariff reduction and another one is minimum market access.

Tariffication means converting non tariff barriers into tariffs that ensures same level of protection. Tariff reduction calls for 36 % tariff reduction by developed countries over 6 years period and 24 % by developing countries over the period of 10 years. The least developed countries do not have any commitments.

Minimum access calls for at least minimum of 5 % of imported agriculture products in domestic consumption by the year 2000 in developed countries and 2004 in developing countries. The less developed countries are exempted from this obligation.

Domestic Support or Domestic Subsidies

This provision calls for reduction of domestic subsidies that result in lower price of exported products and distort free trade. These subsidies are called **Amber Box subsidies.**

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Under this provision, the Aggregate Measurement of Support (AMS) is to be reduced by 20% over a period of 6 years by developed countries and 13 % over a period of 10 years by developing countries over the base period of 1986-88.

Aggregate Measurement of support means the total of product specific subsidies and non-product specific subsidies provided by a country in a year. Product specific subsidies mean the subsidies given to particular product. For example, cotton, rice etc. Non-product specific subsidies mean subsidies given in general and not specific to any product, say fertilizer subsidies that benefit all agricultural products.

In the calculation of AMS, the subsidies are not included when the support is within the de-minimis[1] level. De-minimis level means the minimum level prescribed by AoA. The de-minimis level for developed countries in case of product specific subsidies is 5% of total value of that particular product produced in a year, for developing countries it is 10%. For non-product specific subsidies, it is 5% of total value of all agricultural products produced in that country in a year for developed countries and 10% for developing countries.

Apart from de-minimis subsidies, following three categories of subsidies are also not included in the calculation of AMS. They are: Green box subsidies, Special and Differential treatment box (S&D Box) subsidies and Blue box subsidies.

Green Box Subsidies

Green box subsidies are those subsidies which don't distort or distort the free trade or production very minimally. The Annex 2 to AoA observes "Domestic support measures for which exemption from the reduction commitments is claimed shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production." [2]

These supports shall be provided through publicly funded government programme and these supports shall not provide price support to the producer. The examples of these kinds of supports are expenditure on agricultural research, training and pest control etc.

Special and Differential Treatment Box (S&D Box) Subsidies

The assistances which are essential for rural development and upliftment of poor farmers are called S&D box subsidies. While Green box subsidies are available to all countries, Special and Differential treatment box subsidies are not available to developed countries. These subsidies are government assistance to encourage

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1 De-minimis means 'of little or small importance'

2 http:// www.wto.org /english /docs_e/legal_e/14-ag.pdf

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agricultural and rural development which is in the nature of rural development programmes of developing countries, agricultural investments subsidies which are generally available to low- income or resource poor producers in developing countries.

Blue Box Subsidies

Blue box subsidies are direct payments under production limiting programmes.

Export Subsidies

The subsidies that subsidise export are called export subsidies. These are direct subsidies given by government or government agencies either in cash or in kind to producers of agriculture products against export performance and export of non- commercial agricultural product at lower price and transport subsidies etc.

The developed member countries have to reduce subsidised export in value terms by 36% and in terms of volume by 21% over a period of 6 years below the level of 1986-90. For developing countries, it is 24% and 14% respectively over a period of 10 years.

Agreement on the Application of Sanitary and Phytosanitary Measures

This agreement sets basic rule to ensure food safety and life/health of plant and animals in member countries. Under this agreement member countries are allowed to set health and hygienic standards of imported products. The standards set should be non discriminatory, scientifically justifiable and to the extent required and not prohibitive in nature.

Trade Related Intellectual Property Rights (TRIPS)

Intellectual properties are knowledge oriented creations, inventions and innovations. The WIPO (World Intellectual Property Organisation) observes as: "Intellectual property (IP) refers to creations of the mind: inventions, literary and artistic works, and symbols, names, images, and designs used in commerce".[40] The intellectual property rights refer to the recognised ownership of the intellectual property to creator, inventor and innovator. The ownership is ensured through copy rights, patents etc. TRIPS cover Copy right and related rights, trademarks including service marks, geographical indictors, industrial designs, patents, lay out designs (topographies) of integrated circuits, trade secrets.

Copy Right

Copy Rights is related with literary and artistic works like books, lectures, sermons, music etc. The copy right means the right conferred on creator, author and producer etc. The rights are protection rights and authorisation rights. The protection right means the right of the author to protect his work from being copied by others. The authorisation right means the right to

3 http://www.wipo.int/about-ip/en/

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author to allow others to reproduce, copy etc., against which he can claim pecuniary benefit.

Trade Mark

Trade mark means the symbols that give unique identity to products of particular producer. The Trade Marks Act 1999 observes as follows ""trade mark" means a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours"[4]

If trade mark rights are conferred to any one, others are prevented from copying or using of that trade mark.

Geographical Indicator

Geographical indicator means the unique identity attached to a particular product for the reason that particular product is produced in a particular geographical location. It may be natural product or manmade product. For example, Banaras silk sarees, Coimbatore wet grinder etc.

The Geographical Indications of Goods (registration and protection) Act, 1999 observes "geographical indication", in relation to goods, means an indication which identifies such goods as agricultural goods, natural goods or manufactured goods as originating, or manufactured in the territory of a country, or a region or locality in that territory, where a given quality, reputation or other characteristic of such goods is essentially attributable to its geographical origin and incase where such goods are manufactured goods one of the activities of either the production or of processing or preparation of the goods concerned takes place in such territory, region or locality, as the case may be".[5]

If geographical indication is given to any product others cannot use that name. For example, if Banaras silk saree is conferred with Geographical indication, others can produce silk saree but cannot claim that their saree is Banaras silk saree.

Industrial Designs

Designs when recognised as it belongs to anybody, others cannot use that design. The Designs Act, 2000 observes "design"means only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article whether in two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye" [6]

Patents

Patent means recognition of invention and

4 http://ipindia.nic.in/tmr_new/tmr_act_rules/tmr_act.pdf

5 http://ipindia.nic.in/ipr/gi/gi_act.PDF

6 http:// ipindia.nic.in /ipr/design/design_act.PDF

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conferment of certain exclusive rights to inventor. The **exclusive right** means the right for production and marketing only by inventor and, if he wishes, to authorise others to produce the product using the invention made by him.

The patents are of two types. One is product patent and the other one is process patent. The **product patent** means the right to produce the product and right to authorise others to produce that particular product is available only to inventor. Others cannot produce that product without authorisation. The **process patent** means the inventor has sole right regarding the processing method and not for the product. Others can produce the product using different processing method.

Topographical Design (Integrated Circuit Lay Out Design)

Layout design means design of integrated circuits, transistors and other circuits. If recognized and the right is conferred to designer, others cannot reproduce it, import it and distribute it.

Trade Secret

Trade secret means the information regarding process, formula etc. The WIPO observes "Broadly speaking, any confidential business information which provides an enterprise a competitive edge may be considered a trade secret. Trade secrets encompass manufacturing or industrial secrets and commercial secrets".[7] For example, a company may use an efficient method of production that leads to cost reduction. It is a trade secret.

Trade Related Aspects of Investment Measures (TRIMS)

TRIMS are essentially to promote investment and equality among countries in the sphere of foreign investments. It calls for countries to avoid unnecessary conditions attached with foreign investments like employment opportunities for local people, limit to imported contents of products produced etc.

General Agreement on Trade in Services (GATS)

GATS call for liberalisation of trade in service sector. This is counterpart of GATT which covers merchandise trade. This agreement covers only commercial service excluding air transport service and excludes government services which are not in the commercial nature. The services are classified into four modes.

Mode 1 (Cross border supply): Cross border supply means export of service across border from domestic country like BPO and Banking services through e-media etc.

Mode 2 (Consumption abroad): Consumption abroad means the services availed by citizens of one country in another country like foreign tour, medical treatment in foreign country, study abroad etc.

Mode 3 (Commercial presence): It means the commercial establishments that provide service in foreign country by establishing subsidiary or holding company in foreign country.

Mode 4 (Movement of Natural Persons): It means, the services provided by professionals like Doctors, Accountants, and Lawyers etc with their physical presence abroad.

This agreement calls for non-discriminatory non-prohibitory and transparent policies related to service trade. This also calls for minimum market access as agreed by member countries.

WTO ROUNDS

WTO was born out of Uruguay round of negotiation as said at the outset. Under WTO, a new round of negotiation was started and named as Doha Round. This fresh round actually started in the year 2001 but declaration and decisions were made in Doha ministerial conference and named after Doha as Doha development round. This round is continuing. This round is concerned with implementation of agreements made in the Uruguay round of negotiation. It covers a whole range of issues from agriculture to e-commerce.

RELATED TERMS

Peace Clause

The Agreement on Agriculture (AoA) has a clause under Article 13 of AoA. This clause restrains other countries from taking counter measure against some of the subsidies given like Green Box Subsidies. This clause also calls for due restraint in taking action against export subsidies and product specific subsidies.

Swiss Formula

Swiss formula gives the rate of tariff reduction. It calls for higher rate of reduction for countries which has higher initial tariff and lower rate for countries which has lower initial tariff. For example, a country with 60 % tariff has to reduce its tariff at a higher rate than a country with 30 %. It means, the former has to reduce its tariff speedily.

7 http://www.wipo.int/sme/en/ip_business/trade_secrets/trade_secrets.htm

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FURTHER READINGS

Yes, this book is an "appetiser" to have 'Indian Economy'. It explains the very basic concepts related to Indian Economy. The intention is, to help beginners. Having said that, the question now arises, yes, I started off with this book ,what to read further?. There are 'n' number of sources to read. The first and foremost which readily comes to the mind of everyone is' internet', in this so called flat world. But, internet is loaded with umpteen number of materials, far and wide. While searching for information, finding the most relevant information ,we need, is a bit tough task. So, I thought to give some ready reference for you, both from internet as well as printed material. Of course, the following are only suggestions with intent to increase your understanding of Indian economy better. These are starter for Indian economy. Therefore, if you are preparing for competitive exam, you can put on hold reading of these starters ,for the time being, for you may run short of time. For that purpose, you can go for books which throw critical analysis and opinions (which are suggested in the last part of this suggestion) which are the main course of your meal.

Starter

For National income, read GROSS DOMESTC PRODUCT(GDP)-AN OVERVIEW (chapter 8) of National Accounts Statistics Sources and Methods 2007, available at http://mospi.nic.in/rept%20_%20pubn/ftest.asp?rept_id=nad09_2007&type=NSSO(Navigation:http://mospi.nic.in>>Home >> Central Statistics Office >> Statistical Manuals). For chapter on Human Development read Human Development Report 2010 or any subsequent year. It is available at http://www.undp.org/content/undp/en/home/librarypage/hdr/human_developmentreport2010.html (Navigation: UNDP.org >> Home >> Research & Publication >> Human Development Reports)

To know further about Poverty and Unemployment and some other socio economic concepts which are not covered in this book, read e-book Concepts and Definitions Used in NSS, available at http://mospi.nic.in/Mospi_New/upload/nsso/concepts_golden.pdf?status=1&menu_id=49 (Navigation: mospi.nic.in >> Home >> National Sample Survey Office >> Survey Design and Research div. >> Major

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NSS concepts >> Concepts and Definitions used in NSS) and Report of The Expert Group to Review the Methodology for Estimation of Poverty available at http://planningcommission.nic.in/eg_poverty.htm(Navigation Planning commission.nic.in >> Home >> Reports >> General Reports). To enrich your knowledge on Indian Financial System, read e - books published on the occasion of Platinum Jubilee celebration of RBI named Reserve Bank of India – Brochure explaining RBI's Role and Functions in brief and Reserve Bank of India: Functions and working. Both the books flow on same line but the first one deals with the functions of RBI briefly and the later one deals elaborately. These are available at http://www.rbi.org.in/scripts/AboutusDisplay.aspx(Navigation rbi.org.in>> Home >>About us).

For Money Stock Measures in India, refer Report of Working group on 'Money Supply: Analytics and Methodology of Compilation' and an article named New monetary aggregation: An introduction, RBI Bulletin October 1999.

For Chapter on Inflation and Deflation, read manual on Compilation of Wholesale Prices in India available at http://eaindustry.nic.in/WPI_Manual.html and WPI compilation Manual available at http://eaindustry.nic.in/WPI_Manual.pdf (Navigation eaindustry.nic.in >> Home >> WPI compilation Manual) and Manual on Consumer Price Index available http://mospi.nic.in/mospi_new/upload/manual_cpi_2010.pdf.(Navigation: mospi.nic.in Home >> Central Statistics Office >> Statistical Manuals).

To know more about the concepts related to Balance of Payments read

Balance of Payments Manual For India http://www.rbi.org.in/scripts/OccasionalPublications.aspx? head=Balance%20of%20Payments%20Manual%20for%20India (Navigation: rbi.org.in >> Home>> Publications >>Occasional)

There are some sources on Indian economy which are not topic specific. ET in the class room, published in Economic Times which comes in question and answer format helps in better understanding of concepts especially new emerging concepts. Oxford companion to economics in India edited by Kaushik Basu is an encyclopedia on Indian economy. It is a collection of many articles written on various issues related to Indian economy. It gives factual as well as conceptual clarity.

Main course

For Main Course of your Indian Economy, read the following book or books. The book, Indian Economy Performance and Policies Authored by Deepashree published by Ane Books Pvt ltd is a simple book. In fact, it is written for B.Com Final year students of Delhi University. A student of Indian Economy needs to have an overall view about Indian Economy, and must constantly update himself by reading current issues .From that angle, this book is enough.

Indian economyby Misra and Puri is still a higher level book. It has very good readability. Indian Economy by Ruddar Datt and K.P.M Sundaram is for ultimate readers. It is a wonderful book, as it critically analyses Indian Economy threadbare with credible data. It is, of course, a socio political and economy reader on India. Though it has biased opinion in some of the areas undoubtedly, it is comprehensive book on Indian Economy.

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TEST YOUR COMPREHENSION

1. NNP at factor cost

a) GNP at market price – depreciation

b) NNP at market price – indirect taxes

c) NNP at market price + subsidies

d) NNP at market price – indirect taxes + subsidies

2. GNP is equal to

a) GDP-Depreciation

b) NNP + Net export of remittances

c) GDP +Net export of remittances

d) GDP + Subsidies - indirect taxes.

3. Disposable Personal Income is equal to?

a) Personal income-Direct taxes

b) Personal income-indirect taxes

c) Personal income+indirect taxes

d) Personal income-Subsidies

4.The National Income was first Calculated scientifically by

a) Findlay Shirras

b) P.C Mahalanobies

c) Dada Bhai Naoroji

d) V.K.R.V.Rao

5. The National Income is being estimated by

a) Planning Commission

b) National Sample Survey organisation (NSSO)

c) Central Statistical organisation (CSO)

d) National Statistical Institute.

6. The new base year for calculation of National Income is?

a) 1999 -2000

b) 2000-2001

c) 1993-1994

d) 2004-2005

7. Which of the following is not a newly introduced index by HDR 2010?

a) Physical Quality Life Index

b)Inequality Adjusted Human Development Index

c) Multi Dimensional Poverty Index

d) Gender Inequality Index

8.Which of the following organisation does bring out human development report ?

a) UNESCO

b) UNDP

c) WHO

d) All these three organisations bring it together

9. Which of the following is true about New HDR ?

a) It puts a cap on per capita income in

measuring standard of living as increasing income has diminishing utility.

b) It put the life expectancy age at 20 years because below that age a society cannot survive

c) It takes the base for education as 10 years of schooling.

d) None of the above

10. Poverty line is fixed on the basis of

a) Per capita monthly income

b) Per capita monthly consumption expenditure

c) Per capita daily calorie intake

d) None of the above

11. Which of the following method is followed by the planning commission for estimation of poverty

a) Mixed recall period method

b) Uniform recall period

c) Engel curve method

d) Lorenz curve method

12. The total number of unemployed is equal to

a) Labour force + work force

b) Labour force – work force

c) Work force - labour force

d) Labour force

13. Read the following statements

i) A person working or being engaged in any economic activity

ii) A person not working but actively seeking employment

iii) A person neither work nor seek employment

Among the above who form labour force

a) i only

b) i and ii only

c) i, ii and iii

d) None of the above

14. Which among the following measures intensity of employment

a) Usual principal status

b) Current weekly status

c) Current daily status

d) All the above

15. Which of the following unemployment cannot be eliminated

a) cyclical unemployment

b) disguised unemployment

c) under employment

d) natural unemployment

16. Which one of the following is revenue receipt?

a) Compulsory deposits

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b) Recoveries of loans

c) Dividends and profits

d) Market loans

17. Fiscal deficit is equal to

a) Total Expenditure – total receipts

b) Budget deficit – interest payments

c) Total expenditure – total receipts other than borrowings and liabilities

d) Capital expenditure – Capital receipts

18. Among the following which one is direct tax?

a) Fringe benefit Tax

b) Sales Tax

c) Service tax

d) Excise duties

19. As per FRBM act in which year the revenue deficit should be zero?

a) 2006 – 2007

b) 2008 – 2009

c) 2009 – 2010

d) 2007 – 2008

20. In which year railway budget separated from general budget?

a) 1914

b) 1952

c) 1948

d) 1924

21. Which committee recommended the introduction MODVAT?

a) L.K.Jha Committee

b) Raja Chellai Committee

c) Kelkar Committee

d) Chandrasekhar Committee

22. Tax on tax for specific purpose is called

a) Surcharge

b) Additional duties

c) Counter veiling duties

d) Cess

23. Among the following which come under the jurisdiction of state governments?

a) Corporation tax

b) Customs duties

c) Land revenue

d) Stamp duties on financial document

24. Match the following

A) Service area approach	1. 1995
B) Regional rural banks	2. 1972
C) Differential interest rate scheme	3. 1975
D) Rural infrastructure development fund	4. 1988

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Codes

	A	B	C	D
a)	4	2	1	3
b)	3	2	1	4
c)	1	2	3	4
d)	4	3	2	1

25. First fully owned Indian Bank is

a) Oudh Commercial Bank

b) Punjab national Bank

c) Bank of Punjab

d) State Bank of India

26. Commercial banks and financial institutions are raising additional funds by means of

a) Commercial papers

b) Term deposits

c) Certificates of deposits

d) Treasury bills

27. Which one is selective credit control tool

a) Liquidity adjustment facility

b) Bank rate

c) Variable reserve ratio

d) Regulation of margin

28.National housing bank is subsidiary of

a) LIC housing

b) RBI

c) HDFC

d) HUDCO

29. Which of the following system is followed by India for issueing money?

a) Mixed exchange system

b) Fixed fiduciary system

c) Proportional reserve system

d) Minimum reserve systems

30. Which of the following is not a Nationalised bank?

a) Indian Overseas Bank

b) Dena Bank

c) Bharath overseas Bank

d) United Commercial Bank

31. Which of the following condition has to be satisfied by a scheduled Commercial Bank?

a) It should be an Indian Bank

b) It should have reserve of more than ₹ 50 Crore.

c) It should have branches in backward areas

d) It should have paid up capital of not less than ₹ 5 lakhs

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32. The Market where the overnight borrowing and lending takes place is called as?

a) Short notice market

b) Call money market

c) Treasury bill market

d) Ad hoc treasury bill market

33. Among the following which one is quantitative method of Credit control?

a) Bank rate policy

b) Variable portfolio ceiling

c) Variable capital-asset ratio

d) Regulation of margin requirements

34. What is the target for agriculture under priority sector lending?

a) 13.5%

b) 4.5 %

c) 40%

d) 18%

35. Which among the following is true about Non Banking Financial Companies (NBFCs)?

a) NBFCs cannot accept fixed deposits

b) They are part of clearing arrangement

c) They cannot accept saving deposits

d) NBFCs are regulated under Banking regulation Act.

36. Which of the following is a public issue?

a) Private placement

b) Sweat equity issues

c) Rights issue

d) None of the above

37. Which of the following is true about depositories?

a) They accept deposits from stock brokers

b) They keep the share documents of brokers and sub brokers in their custody

c) They keep the securities in electronic format

d) They buy undersold shares

38. Sensex is the index of

a) Top thirty companies in NSE

b) Top fifty companies in BSE

c) Top thirty companies in BSE

d) None of the above

39. Which of the following is not a RBI controlled NBFC ?

a) Asset finance company

b) Loan company

c) Investment company

d) Merchant Banking company

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40. Which of the following is not part of 'Other Deposits with RBI'?

a) Deposits of quasi-government and other financial institutions including primary dealers

b) Balances in the accounts of foreign central banks and governments

c) Accounts of international agencies such as the IMF etc, and

d) Provident, gratuity and guarantee funds of government employees

41. Which of the following is the formula of money multiplier

a) M_3/M_1

b) M_1/M_3

c) M_3/M_0

d) M_0/M_2

42. When inflation rise above 20% it is called as

a) Galloping inflation

b) Walking inflation

c) Trotting inflation

d) Running inflation

43. From October 2009 WPI inflation is being calculated

a) Weakly

b) Bimonthly

c) Fortnightly

d) Monthly

44. Price rise due to increase in the wage is called?

a) Demand pull inflation

b) Disinflation

c) Cost push inflation

d) Stagflation

45. In case of Deflation who among the following is the loser?

a) Fixed income group

b) Creditors

c) Consumers

d) Debtor

46. Balance of Payment is a systematic record of

a) Money inflow and out flow of Government.

b) Money inflow and outflow of private and Government Companies &, corporation, Enterprises.

c) Money inflow and outflow of the country as a whole.

d) Government's transaction with international financial bodies like IMF, world Bank etc.

47. Which among the following is / are true?

a) Balance of Trade is always equal (Zero).

b) Balance of Trade is always Positive (favourable).

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c) Balance of Capital account is neither positive (favourable) nor negative (unfavorable).

d) Balance of Payment is always equal (Zero).

48. Which among the following come under capital Account?

a) Purchase of property in a foreign country.

b) Official sale of reserve.

c) Shipment charge for capital goods by a ship.

d) None of the above

49. What is the purpose of Purchasing Power Parity based exchange rate?

a) Merchandise Trade invoice.

b) International economic comparison.

c) To bring uniformity in the Balance of payment accounting system throughout the world.

d) To fulfill the IMF mandate.

50. Voluntary increase in the value of domestic currency against a foreign is called as?

a) Depreciation

b) Revaluation

c) Appreciation

d) Devaluation

51. Which of the following is top level organisational structure of WTO?

a) General council

b) Ministerial conference

c) Dispute settlement body

d) Goods council

52. Which of the following is not covered by TRIPs agreement?

a) Patent

b) Service mark

c) Trade secret

d) None of the above

53. The principle of Most Favoured Nation calls for

a) Equal treatment for foreign goods and domestic goods in internal sale and consumption

b) Equal treatment for import from all countries

c) Giving special treatment for goods imported from developing and least developed countries

d) Giving market access to agricultural product

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ANSWERS

1.d	2.c	3.a	4.d	5.c	6.d	7.a	8.b
9.b	10.b	11.b	12.b	13.b	14.c	15.d	16.c
17.c	18.a	19.b	20.d	21.a	22.d	23.c	24.d
25.b	26.c	27.d	28.b	29.d	30.c	31.d	32.b
33.a	34.d	35.c	36.d	37.c	38.c	39.d	40.d
41.c	42.a	43.d	44.c	45.d	46.c	47.d	48.a
49.b	50.b	51.b	52.d	53.b			

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Mr. K. Sankarganesh is passionate on Economics and Socio Economic matters. Being a university topper during the Under Graduation, his specialization greatly lies with Public Finance. He got wide exposure in writing articles on Current Economic Issues in popular magazines. An ardent reader of Tamil Literature and interested in creative literature also.

At present, Mr. K. Sankarganesh is working as an Assistant Commissioner of Income Tax in Chennai, Tamil Nadu. He belongs to 2010 Batch of IRS.

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